Part B
The Framework & Strategy for the Sustainable Public Finances of an Independent Scotland

May 2018
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B1 SCOTLAND’S PUBLIC FINANCES

B1.1 Part B of the report considers the public finances and the governance and strategy required to ensure they are managed sustainably and with credibility, predictability and transparency. It makes recommendations on the strategy to manage them sustainably and put a credible and respected governance framework in place purposefully.

B1.2 This is critically important for any country and especially important for a newly independent country as it transitions to its new governance framework. Those who are required to contribute, or manage, taxation revenues deserve as much foresight and insight on what they will be asked to pay and how. And, of course, the providers of debt finance to sovereigns require comfort that contractual commitments made to them will be honoured and underpinned by credible long-term governance and policy.

B1.3 For the purposes of our analysis we have chosen a particular year, commencing 2021-22, as this is the end of the current planning horizon. This should, in no way, be taken as a target date for an independent Scotland. The decision on when to hold an independence referendum is clearly not one for the Commission. However, choosing a specific year aids the analysis as it allows illustrative numbers to be used. The choice of starting point is not relevant for the overall approach.

B1.4 The analysis then examines governance examples and experience from our benchmark group of small advanced economies around the world and makes a series of recommendations for the consideration of the First Minister.

B1.5 Clearly the policies undertaken by any independent Scottish Government will depend on the choices made by the electorate in choosing their government. What the Commission’s work seeks to do is provide a framework against which future choices may be made, especially through the first five to ten years of transition.

B1.6 Whatever it inherits financially on day one of independence it is critical that the Scottish Government moves purposefully to establish credibility and stability in the public finances as it will, for the first time, be going directly to debt markets to seek funding.

B1.7 As things stand this will require a clear strategy to get the inherited deficit to manageable levels, in an orderly fashion, over a period of time that is sensible. It will also require a clear policy for the on-going containment of debt. Getting this right is one of the core pillars of creating the success of the newly independent country and its economy and the living standards its citizens enjoy.

B1.8 In managing this transition, it is also important that the Scottish Government is careful about the role of public finance policy in stewarding and contributing to the broader economic performance of the country. We can observe from the policy performance of the UK Government in recent years that there is a risk that a counter-productive impact on growth can result from mistimed or poorly considered budget choices. It is a truth that bears
repeating that managing the public finances is not a zero-sum game of taxation and spending. The critical underpinning is the health of the economy and tax base. The health of the economy over the longer term should be uppermost in the minds of policymakers when making decisions about the budget in the short term and in determining the best course for fiscal sustainability.

B1.9 That is not to say that there is any easy route to fixing the public finances from the current model from which they are inherited, there is not. But there is material value – as the evidence from the small advanced economies demonstrates – from tailoring policies to the Scottish economic interest while purposefully securing the credibility we require in creating a sustainable base for the public finances.

B1.10 The recommendations set out in this part of the report do not rely on increasing the growth rate. However, there is no doubt that increasing the long term rate of growth would make the task of fixing the public finances considerably easier. Realising the ambitions set out in part A of this report would mean that the targets set in part B would be achieved earlier and a wider range of options would be available for longer term fiscal management.

The Politics of Scotland’s Public Finances

B1.11 The politics of this debate have dominated Scottish political discourse for many decades. The motivation for this is clear but not relevant for the purposes of this report. In fact the existence of the Government Expenditure and Revenue in Scotland (GERS) report provides a helpful starting point for our analysis, giving a greater degree of information and transparency that might otherwise be missing. GERS of course allocates revenues and spending according to the accounting conventions of the central government, not necessarily where they actually arise as would happen under the UN or Eurostat convention on national accounts. Thus, given these assumptions and the lack of discrete data on Scotland, the GERS analysis can only be an estimate of Scotland’s position that reflects the current constitutional situation. What we can observe from the performance of the Office for Budget Responsibility and the UK Treasury is that forecasting public finances, and the economy, is difficult. This is true of all countries of course.

B1.12 Therefore, for our purposes in this report we use the latest Government Expenditure and Revenue Scotland 2016-17 as our starting point and project this forward leaning where we can on independent analyses such as the Institute for Fiscal Studies, John McLaren’s Scottish Trends and the Fraser of Allander Institute.

B1.13 This should ensure that the initial assessment of the ‘starting point’ is non-controversial. We then make proposals for policy that would not be dependent on any one growth outcome although, obviously, the better the growth performance the better the public finances.

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1 The Scottish Government (August 2017), Government Expenditure and Revenue Scotland 2016-17
2 John McLaren (March 2017), Scottish Trends: Analysis of key economic and fiscal issues impacting on a 2nd Scottish independence referendum
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B1.14 What is undoubtedly true is that the current position of the country’s public finances is an imperative for change rather than staying the same. And it is a reflection of the policies and structures that have created the scale of the deficit as it stands, rather than on those that would seek to put it right. And, of course, this analysis can make no assumption about the ability of the Scottish Government to tailor policies to secure faster growth and therefore, reduce the deficit.

B1.15 In political terms, we present a choice for making Scotland’s public finances sustainable, purposefully and by our own efforts. It is for others to then judge whether this is preferable to having them ordered in the same manner that got us to the current position in the first place.

B1.16 In addition, the prospect of an extreme Brexit, with Scotland out of the EU and Single Market as part of the UK, is almost certain to make the situation worse, with tax revenues depressed and the very real possibility of a falling working population.

B1.17 Given the nature of Scotland’s economy, society and geography there is no doubt that the challenges facing the country are distinct from many parts of the rest of the UK. Economies that are resource rich with a large landmass and a relatively small population should be able to steward their resources in a way that secures sustainable revenue sources.

B1.18 At the same time the delivery of public services can be more expensive than in smaller urbanised geographies. Moreover, the price that Scotland continues to pay for the disorderly management of its post war industrial ‘transition’ provides an imperative for social policy cohesion and a focus on improving economic participation as we note in Part A.

B1.19 The opportunity in all of this, for a Scotland with the fuller powers of an independent country, is that it can purposefully address its challenges while taking far greater benefit from its opportunities. Culturally, having rounded responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all.

B1.20 Finally, a word on North Sea Revenues: Like the deficit discussion the debate on North Sea Revenues has been framed negatively over the last forty years and more to the detriment of its effective stewardship. It has long been SNP policy to establish a Fund for Future Generations. Successive UK Governments have failed to do this. Looking forward it is our judgement that windfalls such as those that occur from the depletion of scarce natural resources should be treated as windfalls and not depended upon for recurring annual commitments. We have proceeded on this basis. Recent investments in the North Sea and the recovery in oil prices suggest an independent Scotland should be able to reap the long-term benefits of oil revenues for many years to come if they are stewarded sensibly.

B1.21 Taken together this report should give everyone considering the future of Scotland and its public finances a sense of confidence that the country has both the imperative and wherewithal to manage itself with far greater ambition and sustainability than it has been
over the last few decades. How we collectively choose to equip ourselves to achieve this is a separate debate. That this is doable and must be done, should be beyond doubt.

B1.22 Accepting responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all. While this report considers the public finances of an independent Scotland, it is not inconceivable that many of the positive recommendations detailed here could be implemented in advance of such a move.
B2 ANNUAL SOLIDARITY PAYMENT

- An agreement should be sought for a mechanism for Scotland to pay a reasonable share of the servicing of the net balance of UK debt and assets.
- This same mechanism could also include payment for continuing shared services and co-operation for example in the area of international aid for a limited or extended period.
- We strongly recommend that the tone and approach of Scotland to the rest of the UK in those discussions should be informed by the recent and on-going difficulties created by the UK Government’s approach to Brexit negotiations.
- Our goal in advance of any independence choice and beyond should be to maintain a relationship that is respectful and as close and positive as between any countries anywhere.

B2.1 Before we introduce the detail of the report we make an initial recommendation for policy that will set an appropriate framework for managing some of the more important negotiation points and transitions to follow. The tone set by Scotland to the rest of the United Kingdom must be positive, responsible and respectful of the fact that we are the party that is changing the arrangements.

B2.2 It will be in the interests of the UK Government and the Scottish Government to pursue an orderly period of negotiation and transition with a view to safeguarding the national self-interest of both.

B2.3 If a positive approach is taken some services could continue to be contracted from shared institutions for a transitional or extended period. The most obvious of these in the immediate short term is International Aid. Scotland will wish to fulfil its United Nations obligation to pay 0.7 per cent of its Gross National Income in foreign aid. In order to provide certainty for some aid recipients it may therefore be favourable to both governments for Scotland to meet its obligations via a funding of UK programmes for a transitional or, indeed, an extended period.

B2.4 Similarly, while it is clear that there is no obligation to do so, we recommend Scotland could and should choose to make a contribution to the servicing of historic UK debt as part of its demonstration of an appropriate approach without prejudicing the outcome of the negotiations.

B2.5 As we discuss in the next section the UK Government’s position on this was made clear in January 2014: “a share of the outstanding stock of debt instruments that have been issued by the UK Government would not be transferred to Scotland”\(^3\). By definition this means that an independent Scotland would start with zero debt. However we recommend that a fair and proportionate division of assets and liabilities should be negotiated. The UK

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\(^3\) HM Treasury (January 2014), UK debt and the Scotland independence referendum
Government made clear that such a division of assets and liabilities would be negotiated with the Scottish Government and a contract agreed.

B2.6 The Commission therefore recommends that, in the event of independence, a new Annual Solidarity Payment should be agreed. The level of this must be subject to an analysis of assets and liabilities at the point of independence and respective fair and proportionate shares.

B2.7 We do not as yet know the negotiated outcome but we anticipate that it would mean a payment by Scotland to the UK Government to finance on-going shared services, and to meet an agreed share of debt-servicing costs. We provide an initial estimate in the sections to follow for planning purposes but obviously without seeking to prejudice the outcome of any such negotiations.

B2.8 The existence of this payment we hope sets a tone of respect and good order towards the rest of the United Kingdom with which, we anticipate, an on-going relationship that is as strong, positive and productive as between any two independent countries.

B2.9 Such an approach would be our recommendation in any context but is especially thrown into focus by some initial lessons learned from the less than orderly approach to the Brexit discussions so far.
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B3 PUBLIC FINANCES: ASSETS & LIABILITIES

- The sustainable management of national debt is mission critical to the UK, as it is to any country. Scotland is no different. Any sustainable government policy should be informed by an appreciation of the assets and liabilities passed to future generations.

- Data is available from the UK government on assets and liabilities held by the public sector across the UK. Scotland’s per capita share of the UK’s non-current assets was £115 billion in 2015-16. After taking account of assets already located in Scotland and (non-pension) liabilities, there would be a net positive balance of £26 billion.

- The fair and equitable division of these assets and liabilities will be the subject of agreement in the event of a positive independence choice. The UK Treasury confirmed in 2014 that existing UK debt instruments remain the responsibility of the continuing UK Government. The UK’s debt will therefore remain the responsibility of the UK Government after Scotland becomes independent. By definition, an independent Scotland will start with zero debt. The strength of that position should not be underestimated. However, an independent Scotland could choose to agree to contribute to the servicing costs of a fair and reasonable share of UK debt (net of a share of assets).

- A negotiated balance to be serviced by the Scottish Government should take account of the balance of assets and liabilities as the UK currently argues in its negotiations with the European Union. We recommend a balance is paid annually to service UK debt instruments and set out our assumptions based on the data we have available. However, we would expect the true value of assets and liabilities to be examined and debated with greater rigour in advance of agreement being reached.

- For the purposes of our report we take a conservative estimate based on OBR projections and the balances noted, and assume an annual debt servicing charge of £3.0 billion (1.6% of GDP in 2021-22.) However this will fall as a percentage of GDP over time, as a result of inflation and economic growth.

B3.1 The focus of the public finance debate in Scotland tends to be on the annual levels of taxation and spending and the net fiscal balance - that is, whether Scotland’s public finances are in surplus or deficit, and how that compares with UK public finances.

B3.2 However, there is also the balance sheet to consider, the assets and liabilities of the Government. This “stock” position is arguably more important than the “flow” of the deficit but the latter can quickly undermine the former. We judge that a focus on this is material to the effective stewardship of public resources. The unfunded or underfunded nature of many of the UK’s liabilities we judge to be injudicious and imprudent (although this is not unique to the UK). At the same time an effective understanding of the assets side of the balance sheet allows for a true sense of the sustainable financial health of the public finances and for choices to be made that may enhance this. What is true for the smallest company is true for any country. We return to this in section B11 where we learn the lessons from other small
advanced economies and make recommendations for the policy of the Scottish Government.

B3.3 In this section we consider the issue of the inherited and transferred assets and liabilities that would come under the responsibility of the Scottish Government. The first of these is the highest profile, the UK National Debt.

**Context on UK Debt**

B3.4 The terms ‘debt’ and ‘deficit’ are sometimes confused and conflated in political debate and, while related, they refer to different things.

B3.5 A public sector deficit is where government spending is higher than the total revenues collected from taxation in any given year. In these circumstances, it is necessary for the Government to borrow to cover the deficit. This is the ‘flow’ that adds to (or in a period of surplus subtracts) from the stock of historic debt.

B3.6 Public sector debt (or government debt) is the cumulation of past deficits that build up over time, when a Government regularly runs deficits and must borrow. Measures of debt include gross government debt (which includes all government debt) and net government debt (gross debt minus liquid assets).

B3.7 Both deficit and debt figures are sometimes expressed in absolute terms, and sometimes as a percentage of economic output (GDP) to show the burden placed on the economy because the debt ratio reflects the capacity to sustain such a level of debt. This provides a basis for making comparisons between countries and to get a sense of sustainability.

**Historic**

B3.8 At the end of the 2016-17 fiscal year, net government debt in the UK was £1.7 trillion, (equivalent to 86% of GDP), around 14 times the cash value of debt in 1980-81. This does not take account of inflation or economic growth over time. But an analysis of debt as a proportion of GDP does. The ratio of the UK’s government debt to GDP is higher now than it has been since the 1970s but less than in the aftermath of the World Wars and Great Depression (Figure 3-1). It is significantly ahead of the 60% target ratio generally considered to be the sustainable level.

B3.9 Debt that has arisen from deficit funding can reach a point where it is unsustainable. However, debt associated with investment is different (and seen as such by financial markets) since it generates future revenues and growth to service that debt.

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4 Office for Budget Responsibility (November 2017), Economic and fiscal outlook
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Figure 3-1 – UK Historic Debt (as % GDP)

UK's Historic National Net Debt

Source: House of Commons Library (Briefing Paper Number 05745)

B3.10 UK debt is forecast to be more than £1.8 trillion by the early 2020s, equivalent to almost 80% of GDP. However, this includes approximately £400 billion of debt that, because of Quantitative Easing (QE), the Government now owes to itself, thereby reducing the net costs of debt servicing.

B3.11 The sustainability of government debt levels depends on many factors, not least the cost of servicing the debt. In the 1980s, the UK was paying debt interest in the range of 9% to 13% and as a result debt interest payments accounted for a very large proportion of public spending, typically around 10%. This was still as high as 7% to 8% of public spending in the 1990s. Current interest rates are much lower, meaning the cost of servicing current levels of debt now account for less than 5% of public spending.

Comparators

B3.12 The UK’s gross debt means that it is in the top half of most indebted advanced economies, but there are some with considerably higher levels, such as Japan and Italy. Other advanced economies with higher levels of gross debt than the UK include the United States, Spain, France and Canada (Figure 3-2). Similarly, in net debt terms (which nets off government financial assets from gross debt), the UK has higher levels of indebtedness than most advanced economies, but less than the United States, Spain and France (Figure 3-3).
Figure 3-2 – Gross Government Debt in Advanced Economies, 2016

Source: IMF World Economic Outlook Database, October 2017

Figure 3-3 – Net Government Debt in Advanced Economies, 2016

Source: IMF World Economic Outlook Database, October 2017
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Debt and Economic Growth

B3.13 Increasing absolute levels of government debt can be sustainable, so long as spending made possible by the borrowing generates economic growth to the point of reducing the debt/GDP ratio. If the outcome of increasing borrowing is higher economic growth than would otherwise have been achieved, and if taxation revenues associated with that additional economic growth exceed the extra interest payments on debt, the additional borrowing will improve the public finances.

B3.14 For example, consider an economy where total output (i.e. adding all goods and services produced) is around £150 billion per year and the public sector, measured in terms of tax collected, accounts for around 40% (£60 billion). If the Government borrowed £10 billion at a 2% interest rate, it would be necessary to find £200 million per year to pay interest on the borrowing. Growing that economy by just 0.33% (one third of one percent) would add £500 million to the economy, which would be associated with around £200 million in additional tax revenues - enough to meet the interest on the additional debt.

B3.15 All of that said, the debt contract remains fixed while the performance of the economy varies. It is therefore the policy of most small advanced economies that we have examined to get the debt position under control and to sustainable levels and we return to this in our policy recommendations.

Context on UK Assets

B3.16 The Whole of Government Accounts\(^5\) sets out details of government spending and tax revenues as well as other financial details such as the assets and liabilities of the public sector in the UK. This national balance sheet includes all central government departments, agencies, local government and other government bodies (including the Bank of England). The latest year for which figures are available is 2015-16.

B3.17 Each government department also publishes accounts that set out assets and liabilities. This includes the Scottish Government\(^6\), Scottish local government and other public agencies associated with devolved government in Scotland. The accuracy of these valuations has not been scrutinised in any detail or been the subject of much public debate. But they provide a useful initial framework for the purposes of this report.

B3.18 During the 2014 Referendum, the Chartered Institute of Public Finance and Accountancy (CIPFA) published an analysis of Scotland’s public sector finances\(^7\), including estimates of assets and liabilities. Based on 2012-13, CIPFA estimated total assets held by devolved Scottish government and local government at £84.4 billion. Between 2012-13 and 2015-16, Scottish Government and Scottish local government assets increased in nominal terms.

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\(^5\) HM Treasury (July 2017), Whole of Government Accounts 2015-16

\(^6\) Scottish Government (September 2016), Scottish Government Consolidated Accounts 2015-16

\(^7\) CIPFA (2014, Scotland’s Future in the Balance
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by approximately 7%, and so updating the CIPFA estimate to 2015-16 would give a total of around £90 billion for public sector assets already held in Scotland.

B3.19 In 2015-16, the value of UK non-current assets was given as £1.39 trillion (Table 3-1). Scotland’s per capita share of those assets would be £116.5 billion. So if assets already associated with the Scottish Government and its agencies (and local government in Scotland) were valued at £90 billion, this would imply that Scotland would reasonably expect, in addition to assets already held, a share of UK Government assets of £26 billion.

B3.20 Given that many of the UK assets are fixed assets than cannot be easily or quickly converted into liquid assets, it is more likely that this net asset share would be set against a Scottish share of liabilities, such as past debt.

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<th>Table 3-1 – UK Assets (£ billion)</th>
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<tr>
<td>Non-Current Assets</td>
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<tr>
<td>Property, plant &amp; equipment</td>
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<tr>
<td>Investment property</td>
</tr>
<tr>
<td>Intangible assets</td>
</tr>
<tr>
<td>Trade &amp; other receivables</td>
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<tr>
<td>Other financial assets</td>
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<tr>
<td>Total Non-Current Assets</td>
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<tr>
<td>Scottish Per Capita Share</td>
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<tr>
<td>Scottish Government, Agencies &amp; Local Government Associated Assets</td>
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<td>Additional Scottish Per Capita Share</td>
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UK Liabilities

B3.21 In 2015-16, UK liabilities were put at £3.73 trillion more than three-quarters of which were non-current liabilities (not due within a year). This includes net government borrowing & financing of £1,261 billion and net unfunded and underfunded public sector pension liabilities of £1,425 billion.

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9 This could be an underestimate since if identifiable Scottish assets and identifiable assets from other UK nations (e.g. those of local government outwith Scotland and of NHS England), are deducted from the total UK assets and then apportioned on a per capita basis, the Scottish share of UK could be as much as £100 billion. However, for the purposes of this report, we have used the conservative assumption of just £26 billion.
B3.22 The liabilities set out in the Whole of Government Accounts are based on international accounting standards and are for net public sector debt. So, this excludes the debt that the UK Government owes to itself, due to Quantitative Easing, QE, of around £350 billion\(^\text{10}\).

B3.23 The pension liabilities are for public sector pensions only and do not include future state pension liabilities. This is because, unlike public sector workers who have accrued their pension entitlement during the period of employment, citizens are entitled only to a payment under the state pension scheme if they meet certain criteria on the date that payment would be due. The Whole of Government Accounts therefore includes state pension payments as current expenditure but not as a liability in the balance sheet.

B3.24 The unfunded state pension commitments do emphasise the importance of addressing Scotland’s demographic trends, as outlined in Part A, chapter A4, The Imperative of Population Growth.

B3.25 Scotland’s per capita share of those liabilities would be circa £311.2 billion. This would include net government borrowing & financing of £105.8 billion, net unfunded and underfunded public sector pension liabilities of £118.3 billion.

B3.26 Excluding the significant items of government debt and underfunded public sector pensions, the Whole of Government Accounts also include non-current liabilities of £187 billion. A per capita share of this for Scotland would be approximately £15 billion. However, this is approximate to the £15 billion non-debt and public sector pension liabilities already associated with devolved government in Scotland, as identified in the CIPFA analysis.

Scotland’s “Fair and Appropriate” Share of Assets and Liabilities

B3.27 The Whole of Government Accounts that contain the estimates of UK assets and liabilities cover all UK government departments and agencies, including devolved governments and so the UK figures already include the Scottish public sector assets and liabilities.

B3.28 The distribution of assets and liabilities should Scotland chose to become independent would be a matter for negotiation.

Public Sector Pension Liabilities

B3.29 Any historic public sector pension liabilities would be the responsibility of the government that made the commitments to retired and current employees, i.e. the UK Government.

\(^{10}\) It is recognised that at some point in the future the decision may be taken to reverse QE and that this could be done by the Bank of England selling the bonds it holds on the open market, with implications for monetary policy. However, the purpose of this analysis is to calculate a share that Scotland may agree to contribute to on-going UK Government debt servicing costs post-independence and so in that context, the stock of debt net of QE is the relevant basis for the calculation since it is this net debt that has servicing costs.
However, it is likely that the UK Government may wish to transfer the liability to the Scottish Government, as part of a wider agreement and that the Scottish Government would wish to accept. An orderly negotiation is in the direct interest of both parties and would be expected. The costs of this liability to an independent Scottish Government have been included in the expenditure projections presented in this report.

**Government Debt**

B3.30 Based on the 2015-16 Whole of Government Accounts, UK Government borrowing was £1,261 billion. Scotland’s per capita share of this would be £106 billion. However, the OBR is projecting that UK net debt will increase to £1,841 billion\(^\text{11}\) by 2021-22. This includes debt that relates to QE and means that no interest needs to be paid (or more precisely that the interest is paid to one part of government by another part of government) and so there is no effect on the public sector balance. The OBR projections for interest payments are for gross payments of £52.4 billion and net payments of £46.6 billion in 2021-22. Scotland’s per capita share of these net payments would be £3.8 billion equivalent to 2.0% of projected GDP.

B3.31 As HM Treasury recognised in January 2014 (Figure 3-4), the UK’s national debt is a matter for the UK in the event of Scotland becoming independent and cannot be assigned to another government. The holders of the debt have a contract with the UK Government that is not transferable. So, if Scotland did agree to take responsibility for a share of UK debt, the debt itself could not be transferred. It would be subject to an agreement to pay an annual amount to the UK Government for an agreed period as a way of contributing to debt-servicing costs.

B3.32 This debt would still formally be UK Government debt, since it would be existing non-transferrable debt, but would be the basis on which Scotland would agree to contribute to debt interest payments.

\(^\text{11}\) Office for Budget Responsibility (March 2018), Economic & Fiscal Outlook
As a result, the inherited debt position of an independent Scotland would be 0% of GDP. However, we also assume that credit markets will consider the impact of the Annual Solidarity Payment when assessing Scotland’s creditworthiness. The net position of almost £90 billion (after accounting for a share of assets) would be the basis for calculating a reasonable contribution to legacy debt servicing costs and it should be noted that this legacy ratio will fall over time as the economy grows and as a result of inflation.

At the projected costs of servicing UK debt in 2021-22 (2.83%) the annual cost of debt interest would be £3.0 billion, which represents 1.6% of Scottish GDP. To put this another way, netting off a proportionate share of assets would reduce Scotland’s share of debt by almost a quarter, based on the best information currently available, reducing debt servicing costs from 2.0% to 1.6% of GDP.

Of course this sum would be subject to negotiation and agreement but we provide it as an initial estimate based on the best information available to us. This is not an unreasonable assessment of “Fair and Proportionate” but nor should it prejudice any future negotiation as the exact detail of asset valuation in particular should be subject to detailed and independent scrutiny.

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12 Office for Budget Responsibility (March 2017), Economic & Fiscal Outlook projects total UK spending on debt interest payments of £52.4 billion in 2021-22 and debt of £1,841 billion, giving an effective interest rate of 2.83%
B4 UNDERSTANDING SCOTLAND’S INHERITED FISCAL POSITION

• The existing Government Expenditure and Revenue reports for Scotland estimates Scotland’s position within the UK. That is our starting point for analysis. The latest report for 2016-17 identifies a Scottish deficit of 8.3% of GDP.
• Taxes raised in Scotland are sufficient at present to fund all devolved services plus welfare and pensions.
• Scotland contributes substantially to UK tax revenues. It is striking to note that, if London and the South East is excluded, Scotland (excluding oil and gas revenues) contributed 12.6% of the revenues, with 11.3% of the population share, in the latest regional tax statistics.
• We assume North Sea revenues at zero for the purposes of our analysis. That does not mean we are anticipating no revenues. In fact recent investment and revenue projections have been positive. Rather, we recommend that windfalls such as from oil are not allocated to current expenditure but are set aside in a Fund for Future Generations, potentially managed through the Scottish National Investment Bank, for investment in inter-generational projects.
• Approximately 40% of government expenditure allocated to Scotland is by the UK Government.
• From 8.3% in the latest estimates it is anticipated on the basis of OBR and other independent forecasts that the GERS estimate of Scotland’s deficit would be 7.1% of GDP by 2021-22. This would have to come down. However, it should be noted the UK has had a deficit at or above this level in six of the last ten years.
• In making comparisons between the possible position of an independent Scotland and the position if Scotland was to remain within the UK, policy choices by the UK Government, not least to leave the EU, which will impact on tax revenue and spending, must be considered.
• The current planning period suggests a 6% cut in the Scottish budget by 2020-21 by the UK Government in addition to the 5% real terms cut experienced since 2010.
• The UK Government’s intention to leave the EU and European Single Market is expected to lead to slower growth, with substantial downward pressures on spending.
• Scottish Government analysis shows that Brexit could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030 compared to remaining in the EU.
• The Annual Solidarity Payment is modelled at around £5 billion including debt servicing contributions, 0.7% GNP contribution for foreign aid and a further £1bn set aside for other shared services.
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B4 Understanding Scotland’s Inherited Fiscal Position

- Scotland’s replication of UK budget spend currently allocated to Scotland in a number of areas is assumed to be unchanged for our analysis including welfare, pensions, economic development and scientific and university research funding.
- Defence budget assumed at an initial 1.6% GDP, significantly ahead of the small European country average (1.1%) and the 8th highest in NATO. But it represents a saving on UK plans currently allocated to Scotland and presents spending multiplier opportunities for expanding the Scottish economy.
- Two expert reviews are recommended: Comprehensive Review of Inherited UK Spending programmes; Standing Council on Scottish Public Sector Financial Performance.
- We have chosen a specific year, 2021-22, to illustrate the potential starting point of an independent Scotland and a subsequent deficit reduction plan. This should in no way be interpreted as a target date. Rather, choosing a particular year as an illustration allows for realistic forecasts to be made and a better understanding of the choices available.
- As a result of the above analysis we anticipate that in 2021-22 the actual inherited deficit would be, on very conservative assumptions and an acceptance of the GERS analysis, 5.5% of GDP. The difference is explained by the savings from defence (0.4%) and UK central programmes (0.8%) and the impact of net assets/liabilities on the anticipated debt servicing element of the United Kingdom Annual Solidarity Payment (0.4%). This is further adjusted to 5.9% of GDP to exclude North Sea Revenues. This would be the anticipated starting point without any significant policy changes or ambitious growth assumptions.
- This analysis depends on existing UK and Scottish Government published data that will vary over time. However, the direction of travel and broad position detailed should as closely approximate to anticipated reality as any government budget planning can be.

B4.1 The most recent “Government Expenditure and Revenue in Scotland” (GERS) report, for 2015-16 included an estimated public sector deficit for Scotland of £13.3 billion in 2016-17, equivalent to 8.3% of GDP.

B4.2 The GERS report is a statistical analysis of taxation raised from Scotland and of government expenditure in and on behalf of Scotland, as a part of the UK. It is not an analysis of what public finances would look like in an independent Scotland. There are two main reasons.

B4.3 Firstly an independent Scottish Government would be expected to make different decisions on taxation and government expenditure.

B4.4 Second as a small advanced economy, Scotland would not require the same public spending that the UK as a large country has chosen to incur. To put it another way, Scotland

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13 Scottish Government (August 2017), Government Expenditure and Revenue in Scotland, 2016-17
would not have the same level of overhead that it is helping to finance as part of the UK and there would be opportunities related to the greater efficiency in government operations that is generally found in small advanced economies.

B4.5 Furthermore, some of the expenditure that has been allocated to Scotland in the GERS analysis is based simply on a per capita allocation rather than whether Scotland’s fiscal position contributes to that expenditure. Notably, GERS allocates a population proportion of the UK’s debt interest payments to Scotland whereas, as we discussed in chapter B4 this is likely to be the subject of negotiation taking full account of a “fair and proportionate” share of all assets and liabilities.

B4.6 While the GERS publication cannot tell us what might happen to Scottish public sector finances after independence it can provide an initial and helpful insight to assessing what the starting point might be for public finances on Day One of an independent Scotland.

B4.7 For all its conceptual and practical limitations we see very little value in comprehensively challenging the detail of the GERS report; far better to accept its starting analysis and remove the controversy from our deliberations. As with all fiscal projections there is uncertainty. The UK Office for Budget Responsibility (OBR) is laudably transparent about the variations in its forecasts. Between its November 2016 and March 2017 reports it varied the anticipated borrowing requirement in the current year by £16 billion for example. In June 2010, OBR forecast that public sector deficit in 2015-16 would be £17.6 billion (0.9% of GDP), and it turned out to be much larger at £76.5 billion.

B4.8 However the shape of what we come on to analyse and propose demonstrates a framework that can be implemented to provide stability, credibility and certainty. If the outturn proves more favourable the journey to sustainable public finances will be shorter, and vice versa. What must be clear to all affected by Scottish Fiscal Policy is that the intent and purpose of the Scottish Government in implementing this framework is determined and focussed. We come on to recommend a governance framework to secure such an outcome later in the report.

UK and Scottish Public Sector Deficits

B4.9 In 2016-17 total government expenditure associated with Scotland was £71.2 billion. Of that, £42.1 billion was spending by the Scottish Government (and local authorities in Scotland), with a further £29.1 billion of spending by the UK Government allocated to Scotland. Of the total £71.2 billion, £63.2 billion was current spending and £8.0 billion was capital.

B4.10 In 2016-17, total taxation revenues associated with Scotland were £57.8 billion (including £4.3 billion in accounting adjustments).

B4.11 The three taxes associated with the highest proportions of that revenue were income tax at almost £13 billion (24% of taxation revenue excluding accounting adjustments), and National Insurance at over £10 billion (20%) and VAT at just over £10 billion (19%).
B4.12 Table 4-1 displays Scotland’s tax revenues as a proportion of the UK’s total revenues for individual taxes, based on 2015-16. Scotland generated revenue accounting for just less than its population share (8.1% of revenues for a population share of 8.3%), well within the margin of error for taxation receipt estimates. It is also striking to note that if London and the South East is excluded Scotland contributed 12.6% of the revenues, with 11.3% of the population share.
### Table 4-1 – Scotland non-North Sea tax revenues as a proportion of UK tax revenues (2015-16)

<table>
<thead>
<tr>
<th>Description</th>
<th>£ million</th>
<th>Scotland as % of UK</th>
<th>Scotland as % of UK (ex L&amp;SE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population share</td>
<td>-</td>
<td>8.3%</td>
<td>11.3%</td>
</tr>
<tr>
<td>Income tax</td>
<td>12,239</td>
<td>7.2%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Capital gains tax</td>
<td>384</td>
<td>5.4%</td>
<td>10.3%</td>
</tr>
<tr>
<td>Corporation tax (excl. North Sea)</td>
<td>3,208</td>
<td>7.1%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Total Taxes on income and wealth</td>
<td>15,885</td>
<td>7.2%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Value added tax</td>
<td>10,838</td>
<td>8.3%</td>
<td>12.2%</td>
</tr>
<tr>
<td>Fuel duties</td>
<td>2,356</td>
<td>8.5%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Business rates</td>
<td>2,579</td>
<td>9.9%</td>
<td>15.9%</td>
</tr>
<tr>
<td>Stamp tax on shares</td>
<td>1,043</td>
<td>9.8%</td>
<td>12.9%</td>
</tr>
<tr>
<td>Tobacco duties</td>
<td>86</td>
<td>7.7%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Alcohol duties</td>
<td>2,232</td>
<td>9.8%</td>
<td>14.1%</td>
</tr>
<tr>
<td>Vehicle excise duties paid by businesses</td>
<td>292</td>
<td>9.6%</td>
<td>21.8%</td>
</tr>
<tr>
<td>Air passenger duty</td>
<td>175</td>
<td>9.7%</td>
<td>12.3%</td>
</tr>
<tr>
<td>Insurance premium tax</td>
<td>577</td>
<td>12.7%</td>
<td>17.7%</td>
</tr>
<tr>
<td>Environmental levies</td>
<td>219</td>
<td>10.2%</td>
<td>12.8%</td>
</tr>
<tr>
<td>EU ETS auction receipts</td>
<td>147</td>
<td>14.3%</td>
<td>17.6%</td>
</tr>
<tr>
<td>Betting and gaming duty</td>
<td>51</td>
<td>14.7%</td>
<td>16.6%</td>
</tr>
<tr>
<td>Total Taxes on production</td>
<td>20,917</td>
<td>8.6%</td>
<td>12.7%</td>
</tr>
<tr>
<td>Vehicle excise duties paid by households</td>
<td>380</td>
<td>7.9%</td>
<td>10.5%</td>
</tr>
<tr>
<td>TV Licence fees</td>
<td>275</td>
<td>8.8%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Council tax</td>
<td>2,115</td>
<td>7.3%</td>
<td>10.4%</td>
</tr>
<tr>
<td>Total Other current taxes</td>
<td>3,057</td>
<td>7.4%</td>
<td>10.5%</td>
</tr>
<tr>
<td>National Insurance Contributions</td>
<td>9,431</td>
<td>8.3%</td>
<td>12.8%</td>
</tr>
<tr>
<td>Total Other current receipts</td>
<td>15,054</td>
<td>8.6%</td>
<td>12.9%</td>
</tr>
<tr>
<td>Total current receipts (ex. Oil &amp; Gas rev.)</td>
<td>54,913</td>
<td>8.1%</td>
<td>12.6%</td>
</tr>
</tbody>
</table>

Source: ONS (May 2017), Country and Regional Public Sector Finances Year Ending March 2016

**Oil and Gas Revenue**

B4.13 Over the last 30 years, oil and gas revenues have made a significant contribution to tax revenues raised in Scotland. Oil and gas revenues were as high as £9.6 billion in 2011-12
B4.14 Scotland’s fiscal position has dipped because of this fall in oil and gas taxation revenues. However, a large part of the gap has been closed by increases in tax receipts associated with the onshore economy, with revenues increasing by around £6.7 billion over a three-year period (an increase of almost 15%), including an annual 6.5% increase in 2016-17.

B4.15 Much political commentary has associated declining tax revenues from oil and gas with a fall in the oil price. However, published statistics on the oil and gas sector show that tax revenues accounted for 28% of total income in 2011-12 (£34.6 billion in income and £9.6 billion in tax revenues), but this had fallen to 8% of income in 2014-15 (income of £21.2 billion and tax revenues of £1.8 billion) and 0.4% of income in 2015-16 (income of £16.1 billion and tax revenues if £60 million). This is to be expected given that the profits which are taxed will have fallen by more than revenues. However, the UK’s oil and gas tax receipts have also fallen due to policy decisions taken by the UK Government on the taxation of the sector, for example on tax rates (including setting the rate of petroleum revenue tax at zero in March 201615) and tax allowances associated with investment.

B4.16 During the downturn in oil prices, investment has been decreasing (£14 billion in 2014-15 and £11 billion in 2015-16) but from a level that is much higher than earlier in the 2000s. Combined with the focus of the UK sector on reducing production costs and increasing innovation, it is more likely that production levels will stabilise or even increase (as they did in 2016-17). The Oil and Gas Authority’s October 2016 projection16 has production stabilising in the five-year period to 2021 (in volume terms) at a slightly higher level than recent production. What this will mean for taxation revenues will depend on oil prices (or, more specifically the profitability of production), and on the taxation regime in place.

B4.17 If tax revenues from oil and gas do recover, using such revenues for current spending - as the UK Government has done over the last four decades - cannot be judged a prudent or judicious use of a windfall from the depletion of a scarce natural resource.

Scottish Government Spending

B4.18 Of the total £71.2 billion government spending associated with Scotland, £42.1 billion is spending by the Scottish Government (including Scottish local authorities). Almost half of this is accounted for by health and education spending (Figure 4-1).

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14 Scottish Government (September 2016), Oil and Gas Production Statistics 2015-16
15 HM Revenue & Customs (March 2016), Oil and gas taxation: reduction in Petroleum Revenue Tax and supplementary charge
16 Oil and Gas Authority (October 2016), UKCS Oil and Gas Production Projections
The funding regime that has been in place for the Scottish Parliament has, until recently, been based on a system where most funding was provided via a block grant from the UK Government. The recent real terms cuts in the Scottish Budget and the further real terms cut in resource budgets expected by 2020-21, have meant that savings in these budgets needed to be found, and will continue to be necessary.

In this context, planning for additional cuts over and above those already planned is likely to be counter-productive, since much of this spending provides the conditions necessary for economic growth, including high quality health and education systems.

However, this is not to say there should no focus on improving the quantity and quality of the outputs and outcomes from this spending. Indeed, the focus of the sustainable economic growth proposals set out in subsequent reports on improving productivity levels and this strategic effort should apply to the public as well as the private sector.

There is no shortage of ideas for improving public services funded from the Scottish Government's budget. Reviews commissioned by the Scottish Government itself include the Independent Budget Review in 2010 and the Christie Commission in 2011. The priorities and recommendations of the Christie Commission remain valid. They include the design of services based on the needs of people and communities (rather than the service providers), breaking down barriers between departments and agencies and integrating

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17 Crawford Beveridge, Sir Neil McIntosh & Robert Wilson (July 2010), The Report of Scotland’s Independent Budget Review Panel

services, building resilience, prioritising preventative measures, focusing on outcomes and creating more efficiency.

B4.23 Analysis by the Fraser of Allander Institute\(^{19}\) finds that the Scottish Budget in 2016-17 was 5% lower in real terms than in 2010-11, with capital spending down by 12% in real terms. In the period to 2020-21, the Institute suggests that the Scottish Budget could be cut by a further 3-4% and possibly up to 6%. Cuts of that scale would be more than the entire budgets for the Finance and Economy; Fair Work, Skills and Training; Culture and External Affairs; and Rural Affairs, Food and Environment portfolios combined.

![Figure 4-2 - Scottish Budget Scenarios to 2020-21](image)

Source: Fraser of Allander Institute, Scotland’s Budget 2016

B4.24 The UK Government’s intention to leave the EU and European Single Market is expected to lead to lower growth, with substantial downward pressure on spending. Scottish Government analysis shows that Brexit could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030 compared to remaining in the EU. Whatever the challenges and opportunities associated with independence, it is clear that the status quo is not a no risk option, quite the reverse.

UK Government Spending Allocated to Scotland

B4.25 More than 40% of government expenditure in and on behalf of Scotland is spending by the UK Government, some £29.1 billion per year (Figure 4-3). The largest share of this goes

\(^{19}\) Fraser of Allander Institute (September 2016), Scotland’s Budget
towards social protection, which includes pensions, unemployment benefit and other welfare payments - a total of more than £18 billion per year.

**Figure 4-3 – UK Government Spending Allocated to Scotland 2016-17 (Total £29.1 Billion)**

Source: GERS, 2016-17

B4.26 The rest of the expenditure allocated to Scotland is based on actual spending in the few cases where UK Government accounting allows this to be identified. For example, the economic affairs category includes science and technology, where Scotland receives a higher than capita share of the budget, due to its internationally competitive university sector.

B4.27 However, for most categories, the spending is not in Scotland and is simply an allocation, usually on a per capita basis that is designated to be for the benefit of the UK overall, including Scotland. This includes defence, foreign affairs, international aid and other common services spending associated with the administration of the UK Government.

B4.28 This allocated expenditure raises interesting implications for an independent Scotland, since it is not spending that Scotland would be committed to, unless decisions were made to either contribute to UK Government spending on an interim basis (for example, as part of a shared services agreement in areas such as international aid discussed above) or to replicate services currently provided by the UK Government for the UK overall.
Scotland’s Fiscal Deficit – within the UK

B4.29 Scotland’s fiscal deficit, as reported in GERS for 2016-17 was equivalent to 8.3% of GDP\(^{20}\). Based on current forecasts for the UK fiscal deficit from the OBR, that is predicted to fall to 6-7% of GDP by the early 2020s.

B4.30 In March 2017, in Scottish Trends, the former Civil Service Economist and then Coalition Government special adviser John McLaren projected a deficit of 6.3% of GDP for 2021-22 and in May 2017, the Institute for Fiscal Studies projected a fiscal deficit for Scotland of 6.7% of GDP in 2021-22. Whilst these pre-dated the latest GERS report, the forecasts for 2016-17 were close to the actual outturn of 8.3% (exactly in line in the case of John McLaren).

Figure 4.4 - Scotland’s Fiscal Starting Point (IFS)

![IFS Projections for Scotland’s Fiscal Deficit (May 2017)](image)
![Scottish Trends Projections for Scotland’s Fiscal Deficit (March 2017)](image)

Source: IFS (May 2017) & Source: Scottish Trends (March 2017)

B4.31 These projections were also made in advance of the November 2017 OBR report\(^{21}\) which revised its projections for the UK deficit in 2021-22 to 1.3% of GDP from 0.7% in March 2017. Applying this change to Scotland would imply a 2021-22 deficit of between 6.7% (Scottish Trends) and 7.1% (IFS).

B4.32 A 6-7% fiscal deficit is not sustainable and action will be required to reduce it to more sustainable levels. The economic and political reality is that will require to be addressed whatever Scotland’s constitutional position is. Independence allows future Scottish Governments to make decisions on how and in what timescale to reduce such a deficit.

B4.33 However it can be noted that 6-7% is not out of line with recent UK deficit figures – it has been at 6% or more for 6 of the last 10 years.

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\(^{20}\) It should be noted that Scotland’s current budget balance (excluding capital expenditure that would be expected to boost the economy’s productivity in the longer term) is smaller than the net fiscal deficit – over the last 10 years Scotland’s current budget deficit has typically been 2% lower than the net fiscal balance. The implication is that infrastructure spending and public investment have been running 2% lower in Scotland than in the rest of the UK.

\(^{21}\) Office for Budget Responsibility (November 2017), Economic & Fiscal Outlook
The Scottish deficit should therefore be judged to be both fundable and fixable, as is the UK deficit.

Figure 4-5 – UK Deficit

Source: GERS

This report sets out a realistic and realisable plan for dealing with the deficit. It is not clear what the alternative plan would be if Scotland was to remain within the UK. However the evidence from the current planning period for the Scottish budget is for cuts of up to 6% by 2020-21, on top of a 5% real terms cut since 2010. The likely impact of Brexit should also be factored in to any assessment of Scotland’s public finances within the UK.

Scotland’s fiscal position makes very little difference to the overall fiscal balance of the UK, not surprisingly, given that Scotland accounts for a little over 8% of the UK’s population. London and the South East of England had a net fiscal surplus in 2015-16 and most of the UK’s fiscal deficit can be explained by the combined deficit of the rest of the English regions (Figure 4-6). As a proportion of the economy, the Scottish fiscal deficit is similar to that of the rest England (excluding London and the South East) and much less than that of Wales and Northern Ireland (Figure 4-7).
Figure 4-6 – UK Net Fiscal Balances, 2015-16 (£m)

Source: ONS (May 2017), Country and Regional Public Sector Finances Year Ending March 2016

Figure 4-7 – UK Net Fiscal Balances, 2015-16 (% Gross Value Added)

Source: ONS (May 2017), Country and Regional Public Sector Finances Year Ending March 2016

Annual Solidarity Payment

B4.37 As noted in Chapter B2 we recommend that, in the event of independence, a new Annual Solidarity Payment be introduced. Depending on the outcome of negotiated agreements on the fair and proportionate division of the UK’s Liabilities and Assets, and on potential agreements on continued funding of some UK services for a transitional or extended
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B4.38 For the purposes of our analysis we estimate that the debt-servicing element of this is expected to be a maximum of £3.0 billion, as set out in Chapter B3. This would stay fixed in cash terms, and therefore would diminish in real terms over time and as a proportion of GDP as the economy grows. The addition of Foreign Aid (at 0.7% of GDP) would add £1.3 billion and a further £1.0 billion is assumed for other shared service agreements. Taken together we therefore estimate an Annual Solidarity Payment of £5.3 billion.

B4.39 This scale of payment recognises the continuing importance of links with the rest of the UK post-independence.

B4.40 However, over time the scale of the payment would diminish in real terms since the debt servicing costs would remain fixed in cash terms, depending on the structure of the negotiated agreement. Moreover, with economic growth, the payment should become less significant as a proportion of GDP within two or three decades depending on prevailing growth performance, as demonstrated here for illustrative purposes (Figure 4-8 shows that 2% inflation and 2% growth reduces payments associated with UK historic debt serving charges by half within 20 years, expressed as a proportion of GDP).

Figure 4-8 – Annual Solidarity Payment (UK Historic Debt Servicing) Over Time (% GDP)

As % GDP

Inflation 2%
Growth 2%

Source: Sustainable Growth Commission Analysis

B4.41 We fully recognise that the agreed outcome for this element of our proposals could be more or less depending on the outcome of negotiations. It is clearly in both Governments’
interests to negotiate in a positive and orderly way. The Scottish Government does not have zero leverage in those negotiations, in fact quite the reverse. But a broader agreement that is positive, orderly and respectful is important to securing the on-going social, economic and cultural relationship that has been built up over many centuries and that should endure any change of governing arrangements.

B4.42 If negotiations resulted in an agreement to make an Annual Solidarity Payment that was higher than this amount it may not be material to the longer-term deficit performance depending on which components make up the difference. It may affect the timing of the achievement of target policy positions at the margin and so we are confident in the efficacy of both the concept and the central assumption we use for this report’s purposes.

Potential Savings for the New Scottish Budget

B4.43 The position of public finances in an independent Scotland would be a matter for the government of an independent Scotland, and the voters who chose that government. As discussed elsewhere in this report, there are examples of successful small advanced economies with relatively high levels of government spending and taxation and examples of lower levels of government spending and taxation. In all cases, the key issue is that the public finances remain in fiscal balance (other than borrowing for investment) over the economic cycle with debt and deficit policies controlled and credible.

B4.44 However, any debate on the desirable path for an independent Scotland requires an understanding of the starting point that would be inherited from the UK and some agreement also about an orderly transition as credibility is established and stability maintained.

B4.45 So, to establish a baseline position, it is helpful to consider where obvious and immediate savings may be achievable from public spending as well as an on-going approach to ensure efficiency across the public sector.

B4.46 There will be immediate opportunities where the Scottish Government would wish to make different choices quickly in areas currently showing in the GERS calculations, or where Scotland is contributing to UK spending choices, such as defence.

B4.47 Similarly, there are aspects of UK Government spending that are in Scotland and it has also been assumed that these aspects should be at least protected. Specifically, secured spending would include:

- social protection (pensions, unemployment benefit, welfare): £18.1 billion
- economic affairs (enterprise & economic development, science & technology, employment policies, agriculture, forestry & fisheries): £1.0 billion

B4.48 These areas account for £19.1 billion of the total £29.1 billion UK Government spending in Scotland or allocated to Scotland (2016-17 figures).
B4.49 There are areas where it seems likely that the Scottish Government may wish to entirely replicate UK spending (for example, the science budget given its importance as a driver of economic competitiveness in Scotland), areas where lower levels of spending may be required in a small country relative to a big country (for example, defence and foreign affairs) and other areas where there is an allocation of spending to Scotland but where there would be no need for spending by an independent Scottish Government (for example, areas considered to be for the whole of the UK but where the spending does not take place in Scotland, including UK Government administration).

B4.50 These total £7.7 billion in 2016-17 (projected to increase to £8.9 billion by 2021-22). This includes over £3 billion for defence and a further £4.7 billion which includes:

| Table 4-2 – UK Government Spending Allocated to Scotland (Excluding Welfare & Debt Payments) |
|-----------------------------------------------|------------------|
|                                            | £ million (2016-17) |
| General Public Services (Cost of Running UK Government) | 484              |
| International Affairs                          | 810              |
| Economic Affairs, including:                   |                   |
| - Enterprise and Economic Development         | 328              |
| - Science and Technology                       | 441              |
| - Employment Policies                          | 227              |
| - Agriculture, Forestry and Fisheries          | 16               |
| Transport                                      | 792              |
| Public Order and Safety                        | 232              |
| Environment Protection                         | 273              |
| Health                                         | 149              |
| Recreation Culture and Religion                | 397              |
| Education and Training                         | 6                |
| EU Transactions                                | -66              |
| Accounting Adjustments                         | 606              |
| Total (2016-17)                                | 4,693            |

Source: GERS 2016-17

B4.51 It is notable that taxation raised in Scotland would be sufficient to pay for all services currently devolved and to meet all pensions and social benefits currently paid in Scotland by the UK Government.

Transferring UK Spending to Scotland

B4.52 In the early years of independence, it is likely that Scotland would wish to share some services with the UK, while domestic capacity is developed, learning from best practice
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around the world. The proposed Annual Solidarity Payment would recognise that Scotland should contribute to the cost of such services in the meantime should the UK Government agree that this was orderly and appropriate. The estimated initial Annual Solidarity Payment is £5.3 billion.

B4.53 For defence spending, there would be choices about spending directly on defence or having some shared services with the UK, or a mix of both depending on the negotiations and the perspective of the UK Government. This is an area where a degree of continuity would make sense and there is the opportunity for Scotland to make a contribution to the United Kingdom defence budget via the Annual Solidarity Payment. A significant proportion of defence spending that is allocated to Scotland is spent outside Scotland, so there would be a limit to how much defence spending would be practical in Year One, whatever policy decisions were made. For the purposes of estimating the deficit prudently, it has been assumed that initial years’ defence spending policy would be 1.6% of GDP (£3.1 billion in 2021-22 values), which is significantly ahead of the small European country average at 1.1% and would place Scotland as the 8th highest in NATO out of 28 countries. This spending is likely to be heavily focussed on procurement in the initial period which would have potentially very significant positive effect on domestic growth and jobs with a concomitant positive impact on the budget that is currently not felt in Scotland to the same extent.

B4.54 The UK Government spending allocated to Scotland also includes areas that are critical to economic competitiveness and future growth, such as the science and innovation budget and other spending on economic affairs. The science budget includes university research funding, where the Scottish universities have been successful is securing a greater than per capita share of UK funding for many years. An independent Scotland should at least match this spending, just over £1 billion (0.6% of GDP). This analysis also includes a further £0.5 billion to account for other UK spending programmes allocated to Scotland that a new independent Scottish Government may wish to replicate, chiefly in areas that would be expected to boost economic growth.

B4.55 Finally, there are the projections for 2021-22 including oil and gas revenues, which, as a windfall associated with natural resources, should be excluded from baseline fiscal planning. Excluding oil revenues increases the starting point 2021-22 deficit by £0.7 billion (0.4% of GDP).

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22 Defence spending of European countries with a population of less than 10 million is 1.07% of GDP on average, composed of Austria (0.68%), Croatia (1.40%), Cyprus (1.83%), Czech (0.98%), Estonia (2.03%), Finland (1.31%), Ireland (0.45%), Latvia (1.03%), Luxembourg (0.50%), Malta (0.61%), Slovakia (1.03%), Slovenia (0.96%), Sweden (1.08%) Source: European Defence Agency, National Defence Data 2015

23 Source: NATO (March 2017), Defence Expenditure of NATO Countries (2009-2016)
Strategic Spending Reviews

B4.56 As part of the governance for the initial transitional phase the Commission recommends two further expert reviews are undertaken, ideally with a view to acquiring cross partisan support for the recommendations they reach:

A Comprehensive Review of Inherited UK Spending Programmes

B4.57 This should analyse the inherited strategy and choices for spending across the UK programmes identified in Table 4-2 above and report within 2 years. This would not include defence which would be covered separately but the range of spending across the costs of running UK Government, international affairs and the allocation to Scotland of UK spending in areas currently devolved such as public order and safety, environment protection, health and recreation and culture. This could ideally commence and conclude in the period between the referendum vote and the initial independence date but may take longer. It purpose would be to make recommendations for where savings could be made where costs need not be replicated and where greater tailoring to Scotland’s position could produce better outcomes from the spending being made.

B4.58 This analysis shows an improvement in the public finances of around £1 billion from allocated costs of £3.2 billion (the £4.7 billion shown in Table 6-2, less the £1.5 billion for science and innovation and other spending contributing to economic growth which should be at least matched), the equivalent of 0.8% of GDP. This is associated with two effects:

- Savings of £0.4 billion in areas that Scotland contributes to UK costs that will no longer be required (including, more than £50 million allocated to Scotland associated with running costs of the House of Commons and House of Lords, more than £20 million for the Scotland Office and more than £100 million for Whitehall Department running costs that will not need to be duplicated in Scotland); and

- Revenue benefits of £0.6 billion associated with spending that is allocated to Scotland but takes place elsewhere. When these activities are transferred to Scotland After excluding spending that mostly takes place overseas (foreign aid and embassies), there would be a total of £2.4 billion spending that would transfer to Scotland and so generate taxation revenues. Almost 70% of this would be on staff wages and purchases of goods and services and of this, almost 37% would be expected to be taxation revenues, so giving a total of £0.6 billion.

B4.59 In addition, further savings can be achieved over time by creating best in class institutions, reducing the costs of governance (including, for example, the costs of tax collection, which are higher in the UK than in most small advanced economies). The future projections at the

24 Analysis of the Whole of Government Accounts 2015-16 shows that, after excluding social security payments and debt interest, 30% of government spending is on staff costs and 39% on purchases of services (with the rest on pensions and other costs).

25 GERS figures for the onshore economy show that taxation revenues accounted for 36.6% of GDP in Scotland in 2016-17.
end of Section B of this report show a further saving of around 0.3% of GDP. This is a modest saving and a larger saving than this is likely to be possible since some of the allocated spending by the UK Government in areas already devolved can be transferred to Scotland at small marginal cost.

**A Standing Council on Scottish Public Sector Financial Performance**

B4.60 This needs to be a well framed call for an institutionalisation of the pursuit of high performance and best practice and benchmarking across the public sector incentivising, celebrating and rewarding where it delivers better outcomes and efficiencies. Legacy Deficit

B4.61 Overall, the legacy deficit that an independent Scotland would expect to inherit from the UK, based on projections for 2021-22, would be 5.5% of GDP (Figure 4-9)

B4.62 A further adjustment to exclude oil (which would be included in calculations for international comparisons but should be excluded for planning purpose), would give a deficit of 5.9% of GDP.

**Figure 4-9 – Calculating Scotland’s Legacy Deficit Starting Point**

Source: Sustainable Growth Commission Analysis

B4.63 To put the illustrative inherited deficit position in some context, the UK’s net fiscal balance was as high as 13.2% of GDP in 2010-11 and has averaged 6.8% of GDP since the financial crisis in 2008.
B4.64 It should be noted that this is a calculation of the starting point an independent Scotland’s fiscal position - the legacy that would be inherited from the UK. An independent Scottish Government would be able to put in place an alternative fiscal framework (as recommended by the Commission) and to implement policies that would impact positively on Scotland’s fiscal position over time.

B4.65 It may be that the actual position is better than this, or it may be less favourable. This will depend on the performance of the UK budget and the economy in the coming period and on the outcome of negotiated agreements.

B4.66 In summary, while the GERS figures for 2016-17 showed a deficit position for Scotland in the UK of 8.3% of GDP, this is projected to decline to 7.1% of GDP within the current five-year fiscal planning period, by 2021-22 (including the latest OBR revisions, made in November 2017).

B4.67 Were Scotland to become independent, this would be reduced further by lower spending on defence (0.4% of GDP), lower debt servicing costs when a share of net assets is taken into account (0.4% of GDP) and savings from UK Government spending allocated to Scotland (0.8% of GDP), reducing the deficit to 5.5% of GDP.

B4.68 However, excluding oil revenues (0.4% of GDP), which would be allocated to Scotland’s Fund for Future Generations, would take the starting point for the deficit to 5.9% of GDP (Figure 4-10).

**Figure 4-10 – Summary of Deficit Position**

![Chart showing deficit position](chart.png)

Source: GERS, IFS & Sustainable Growth Commission Analysis
B5 SET UP COSTS & INVEST TO SAVE OPPORTUNITIES

- Total set-up costs to establish departments and agencies of around £450 million over 5 years, or £90 million per year for 5 years, based on the analysis of Professor Patrick Dunleavy of the London School of Economics.
- Most of these costs would be associated with establishing four new bodies: a defence force and associated defence ministry, a foreign affairs and trade department, a security and intelligence agency, and a central bank and financial regulator.
- Additional civil service personnel of around 4,100, an overall increase of public sector employees of 1%. The costs of additional personnel based in Scotland will have no additional costs (other than those included in transition costs) since these staff are paid for by Scottish taxpayers already, but based elsewhere in the UK.
- Transition costs recovered within 6 years, from additional taxation revenues from the transferred personnel and activity.
- Net economic impacts are positive and substantial, since the additional income associated with transferred employees exceeds costs, even in the transition period, with additional income to the Scottish economy of almost £226 million per year and additional tax revenues of over £75 million.

B5.1 The analysis set out in this chapter is based on research undertaken by the London School of Economics (LSE), led by Professor Patrick Dunleavy, an expert in public sector institution building and public sector productivity. The focus of the research was on the transition period costs of setting up a new Scottish state (for two years before and three years after independence).

B5.2 The approach taken involved a number of stages. First, the LSE research team put together a comprehensive list of all UK departments, executive agencies and other main QGAs (quasi-governmental agencies) from multiple webpages across the official gov.uk site. They identified and removed all organisations where powers are already fully devolved to the Scottish Government, and those relating solely to other parts of the UK outside Scotland. They also discounted a number of small organisations where they considered it unlikely that it would be necessary or viable for Scottish Government to create free-standing bodies rather than allocating the functions in question to other, larger agencies.

B5.3 In this reduced list they identified departments or agencies that already exist in some form within Scotland, i.e. with staffs, buildings, IT and transaction systems etc. already fully in place, but where the policy-making direction currently comes from Westminster. These agencies already-in-being would need to be somewhat reorganised at the top tier, so that policy making resides with Scottish ministers and the Scottish Parliament. Normally this would entail creating new policy-level staffs and structures (which is relatively inexpensive), and in a few large cases inaugurating a longer-run programme to progressively ‘disentangle’ systems or parts of integrated administrative functions currently run elsewhere
in the UK. But in most cases more deep-rooted reorganisations would not be needed, e.g. of field agencies and implementation systems. In the short term it has been assumed that the Scottish Government could contract with Whitehall departments to continue supplying essential services located outside Scotland for a transition period, at a cost that would be comparable with or only slightly more costly than the current setup.

B5.4 The final category consists of organisations that currently have no counterparts or existence within Scottish Government, or located in Scotland, and hence will entail setting up new departments (in a very few cases) or agencies. Data was collated from countries that are comparable to Scotland in terms of population size (especially Denmark, Norway, Finland and New Zealand, and sometimes Sweden) and adjusted for some relevant differences (such as population size, GDP and governing traditions etc.). Weighted averages provided a basis to estimate what the size of new agencies might need to be and what level of spending would be entailed. This was then compared with other estimates of the UK staffs or spending happening north of the border on comparable functions.

B5.5 It was also assumed that staff already working in Scotland only on delivering services to Scottish residents will remain in post and transfer across to the Scottish Government under ring-fencing arrangements. In practice a certain quota of staff will use this opportunity to retire, and a further proportion may wish to relocate to the remaining UK for family or career reasons. Administrative reorganisations around such changes can often result in significant staff savings. But these would depend on the decisions made by Scottish ministers at the time, who may wish to maintain staffing levels. It was assumed that either replacement staffs would be recruited, or organisation and staffing changes would compensate. However, some key cases where specialist expertise or larger numbers of staff might be involved were also considered.

B5.6 To compute net cost additions the focus was on the two years leading up to an independence date, and the first three years after it. Evidence from an authoritative study of Whitehall reorganisations shows that even the most complex ones were substantively accomplished within three years. This approach also now includes a broader range of costs within the definition of transition-period costs than previous work undertaken prior to the 2014 referendum.

B5.7 The LSE team consulted extensively with a range of experienced UK decision-makers (and some academics) in each of the areas where new Scottish departments or other major institutions would be needed. The LSE team consulted non-attributably to senior people in each of the main cases, and to identify the main dimensions which could bear on costs and timing issues. The LSE team is most grateful to all respondents.

26 White and Dunleavy (2010)
New Departments

B5.8 Creating new institutions will entail costs for the Scottish Government in four areas: a Defence Department and Scottish armed forces, a Foreign Ministry and a diplomatic service, an integrated Security and Intelligence Agency and a central bank and financial regulator.

Defence and Armed Forces

B5.9 As a population pro-rata share of the UK’s current armed forces, the Scottish armed forces would number around 12,600\(^{27}\), and that this total is similar to that in New Zealand (which has a smaller population). However, it is smaller than the armed forces of Norway and Denmark, two NATO ally states. The civilian defence workforce in an independent Scotland would be under 700 staff, if we transpose UK levels on a population-proportional basis. On the UK pattern about half these staff would be in the Defence Department HQ. If Scottish armed forces were somewhat larger, these numbers might increase to around 1,000 civilians.

B5.10 If Scotland committed 1.6% of GDP to defence expenditures it would spend less compared with its population pro rata share of current UK defence spending. It is estimated that in the transition period (two years before and three years after independence) there would be extra costs of around £100 million (so £20 million per annum) in creating a new Defence Department, higher tier armed forces functions and decision-making processes, and in immediately disentangling Scottish defence capabilities from decisional dependence on UK institutions. Substantial contracting for services with the rest of the UK would also be needed, but at only a small cost increment from current provisions.

B5.11 However, although this sum is included within the overall £450 million transition-period costs, it should be noted that these cost increments are likely to be easily absorbed within Scotland’s defence budget because of logistically inevitable spending reductions involved in the early years of creating a new, small-country defence provision.

Foreign Ministry and Diplomatic Service

B5.12 It is estimated that the additional transition period costs of creating a new (integrated) Foreign Ministry would initially be between £100 million (with a minimal embassy spread of 55 countries) and £150 million (covering 80 countries), in addition to minimal population-proportional funding of £135 million a year already covered in Scotland’s share of UK tax receipts. Smaller additional amounts covering salaries for around 200 more staff than already implied (on a population-proportional basis) would also accrue as on-going extra costs.

\(^{27}\) Scottish Government statistics (March 2017) on public sector employment show 10,100 armed forces employees in Scotland and so this would imply an additional 2,500
Security and Intelligence Agency

B5.13 A Scottish Security and Intelligence Agency (SSIA) providing internal and international security, cyber/electronic surveillance agency, defence intelligence and special forces would require 300 to 550 staff and have relatively modest functions, proportional to risks to Scotland. All of its running costs would seem to be more than covered in a population-proportional share of existing UK intelligence and homeland security spending. However, capital costs in creating new IT systems and acquiring secure (temporary) buildings of around £50 million would accrue in the transition period.

Central Bank and Financial Regulator

B5.14 The functions of a central bank and financial regulator are covered in Part C. For the purposes of this analysis we include maximum transition-period costs of £50 million (it could well be less) to cover the run-up costs of establishing a central bank and regulators and acquiring (temporary) secure buildings in the two years of the institutions’ existence pre-independence, before they commence operations. However, the bank and regulator should be able to repay set-up costs (with interest accrued) within its first decade of operations. The staff cost analysis assumes a cohort of 1,500 staff in a central bank and financial regulator (similar staffing levels as in Ireland).

Absorbing and Managing Staff from UK Departments Already Operating in Scotland

B5.15 After independence the Scottish Government will take over major UK administrative systems that operate within Scotland for collecting taxes (HMRC), paying social security (DWP), issuing passports and immigration. ‘Repatriating’ these powers will entail creating new decision-making and control structures in Scotland. The Scottish Government, as a result of the extension of the powers of the Scottish Parliament, has recently established Revenue Scotland and the Scottish Social Security Agency, beginning the development of new systems and the recruitment of expertise which can be extended to deliver the full range of services that would be required under independence. It will also involve ‘disentangling’ some parts of these systems from UK-wide operational structures - although inter-governmental contracting should allow any cost additions here to be modest in the transition period.

B5.16 Other departments and agencies would include:

- Extension of Revenue Scotland (HQ staff of 100, accommodation and some new IT provision);
- Extension of Scottish Social Security Agency (HQ staff of 100, accommodation and some new IT provision, reorganisation cost of £25 million);
- Scottish Passport Office (no additional staff required and marginal transition costs);
• Scottish Border and Homeland Security (additional 150 staff and transition costs of £30 million);
• Single Economic Regulator (like UK regulators fees would be set to cover costs);
• Debt Management and Assets Office;
• First Minister, Cabinet Office and Department of Finance (Up to 240 additional staff and transition costs of £40 million); and
• Other Scottish Government departments (35 additional staff and transition costs of £35 million).

Summary of Transition Costs

B5.17 An independent Scotland would face total transition-period costs of around £450 million in the two years leading up to independence and the first three years immediately afterwards, in creating new administrative structures that duplicate UK institutions – or around £90 million extra costs per year.

B5.18 Most of these costs would be associated with establishing four new bodies:

• a defence force and associated defence ministry;
• a foreign affairs and trade department, along with overseas embassies and representation;
• a security and intelligence agency; and
• a central bank and financial regulator.

B5.19 In addition, there will be smaller costs in:

• adapting central decision-making components to add to the UK administrations already existing within Scotland for collecting taxes (HMRC and Revenue Scotland), paying social security (DWP and Scottish Social Security Agency), and creating functions for immigration, borders and homeland security (Home Office).
• disentangling some parts of these systems from UK-wide operational structures, although inter-governmental contracting should allow any cost additions here to be modest in the transition period.
The transition would also imply an additional 2,500 members of the Armed Forces based in Scotland (since Scotland currently has a less than per capita share of these personnel) and more than 4,100 additional civil servants. These would be permanent positions but would not imply any additional costs since Scottish taxpayers are already paying for these services and departments, but they are located outwith Scotland.

To put this in some context, there are currently 543,000 public sector employees in Scotland, of whom 5,500 are Scottish Government civil servants. So this would represent an increase of 1% in public sector employment and to place this in some context, there were 577,000 public sector employees in Scotland in 2005.

Economic and Fiscal Benefits

The transition of these governance arrangements would provide opportunities to create best in class institutions, and improve the quality of governance and the productivity of public services.

In addition, they would also generate economic and fiscal benefits since the additional public sector staff based in Scotland would result in additional income and taxation income.

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28 Source: Scottish Government (March 2017), Public Sector Employment in Scotland
29 Source: Scottish Government (September 2005), Public Sector Employment in Scotland
B5.24 Table 5-2 summarises the scale of such benefits that would be expected, based on conservative assumptions on salary levels. The armed forces salary levels are based on an average of £20,000, just above the salary of a Private in the army\(^{30}\) and the civil servant salary costs are based on the median salary in the UK civil service of £30,000\(^{31}\), with the exception of the First Minister and Finance departments, and the Central Bank and financial regulator, where an average of £60,000 has been assumed, reflecting the senior nature of these posts.

B5.25 The additional tax revenue estimates have been based on the average tax take from UK households of one third of gross income\(^ {32}\).

B5.26 On this basis, the additional staff would result in additional income to the Scottish economy of almost £226 million per year and additional tax revenues of over £75 million.

<table>
<thead>
<tr>
<th>Additional Staff</th>
<th>Salary Costs (£m)</th>
<th>Additional Tax Revenue (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armed Forces</td>
<td>2,500</td>
<td>50.0</td>
</tr>
<tr>
<td>Defence</td>
<td>1,000</td>
<td>30.0</td>
</tr>
<tr>
<td>Foreign Affairs</td>
<td>590</td>
<td>17.7</td>
</tr>
<tr>
<td>Security Services</td>
<td>425</td>
<td>12.8</td>
</tr>
<tr>
<td>Central Bank &amp; Regulation</td>
<td>1,500</td>
<td>90.0</td>
</tr>
<tr>
<td>Revenue</td>
<td>100</td>
<td>3.0</td>
</tr>
<tr>
<td>Social Security &amp; Pensions</td>
<td>100</td>
<td>3.0</td>
</tr>
<tr>
<td>Homeland Security</td>
<td>150</td>
<td>4.5</td>
</tr>
<tr>
<td>First Minister’s Office &amp; Finance</td>
<td>240</td>
<td>14.4</td>
</tr>
<tr>
<td>Other</td>
<td>35</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>6,640</td>
<td>226.4</td>
</tr>
</tbody>
</table>

Source: Sustainable Growth Commission Analysis

B5.27 On this basis, the net effects of the transition in governance on the Scottish economy would be a positive contribution to the budget, even in the transition period when additional costs are incurred, since the additional income of around £226 million would be greater than the additional costs of £90 million.

B5.28 And the additional taxation revenues of around £75 million per annum would mean that the total projected transitional costs of £450 million would be recouped within 6 years.

\(^{30}\) Source: British Army Rates of Pay (2016)

\(^{31}\) Source: ONS Civil Service Median Pay (2015)

\(^{32}\) Source: ONS (April 2017), Effects of Taxes and Benefits on UK Household Income
B6 FUND FOR FUTURE GENERATIONS

- All future North Sea Revenues should be set aside in a new Fund for Future Generations, along with any other windfalls such as asset sales or one off revenue raisers.
- Such a fund could be established within or invested via the Scottish National Investment Bank, currently being established by the Scottish Government.
- The UK Government has received around £328 billion in real terms revenue from the North Sea production over the past 40 years.
- The role of the Fund would be different in scale and ambition from Sovereign Funds that anticipated the oil boom such as in Norway (the Norwegian fund is worth around £750 billion).
- The focus of this Fund would instead be on risk bearing by the public sector, and on exploiting inter-generational opportunity in the areas of Inclusive Growth, Transformational Innovation and Infrastructure and the Green Economy.
- Further work is required on the detail of its remit and governance.

B6.1 The analysis of the fiscal position of an independent Scotland discounts oil revenues, assuming they will be zero for planning purposes. Oil revenues should be treated as a windfall fiscal bonus. The failure of successive UK Governments to take such an approach is another example of poor fiscal and economic management. The UK Government has received around £328 billion in real terms revenue from the North Sea production over the past 40 years.

B6.2 As has been shown repeatedly, oil revenues are difficult to forecast. HM Treasury and the OBR failed to predict both the oil price rise and high oil revenues at the start of this decade and the more recent reduction in oil prices and revenues.

B6.3 It should however be noted that the decline in oil revenues in recent years has not been entirely because of the fall in oil prices but also due to UK Government policy decisions. Oil prices have fallen by around 40-45% since 2014 and output has increased by 15-20%. Therefore, market conditions only account for a proportion of the reduction in oil revenues. The driver has been policy decisions on rates to reduce tax revenues from the oil and gas sector and allowing producers to set decommissioning costs against past investment to reduce tax liabilities.

B6.4 Even based on this policy environment, the OBR forecast in December 2016 oil revenues for 2017-22 of £7.3 billion, which it then reduced to £4.6 billion in March 2017 and £3.3 billion in November 2017 and then increased again to £5.5 billion in March 2018. At least 80% of these revenues would be associated with Scotland’s geographic share of oil and gas revenues.
B6.5 The Commission recommends that revenues of this kind should be placed into a Fund for Future Generations, along with any other windfall income, such as from asset sales. Such a fund could be established within or invested via the Scottish National Investment Bank, currently being established by the Scottish Government.

B6.6 This would be different in both scale and purpose from other oil funds, such as the Norwegian Fund. The size of that fund reflects the foresight of the Norwegian Government in setting it up while oil revenues were particularly high rather than spending the windfall as happened in the UK. The Norwegian Fund is largely used to invest overseas, which helps manage the exchange rate and is worth around £750 billion.

B6.7 The situation in Scotland is different and, therefore, the Fund for Future Generations should have a different role. It would be an investment fund that would allow for long-term policy making, investing to achieve a return on capital but in projects that also generate growth in Scotland and associated fiscal benefits. The risk bearing long-term projects will focus on the areas of Scottish need, opportunity and comparative advantage, including on:

- inclusive growth initiatives;
- transformational innovation and infrastructure (additional to investments that would be usually be associated with existing programmes and infrastructure provision); and
- the green economy (including the next generation of renewable energy technologies).

B6.8 The governance and strategy for the fund should be consulted on in detail and an initial assessment produced by the Scottish Futures Trust in conjunction with expertise from the Scottish Investment industry and the new Scottish National Investment Bank. The returns in some policy areas may be less simple to calculate and recoup than in others. An early challenge for the set up for the fund will be deciding on how it will obtain a return where the initiatives it has invested in produce financial value for the exchequer that is not directly returned to the fund. The most obvious of these would be programmes to encourage economic participation.
Part B: The Framework & Strategy for the Sustainable Public Finances of an Independent Scotland

B7 FISCAL FRAMEWORK & GOVERNANCE: INTERNATIONAL EVIDENCE

• There is a wide variety of evidence of how other small advanced economies have reduced deficits to a healthy and sustainable position. Indeed, many of the fiscal challenges experienced by those economies represent far greater problems than would be inherited by Scotland on our analysis. Scotland’s fiscal starting point is challenging, but it is a proposition that is fundable; and making it quickly sustainable is both achievable and essential whether Scotland is independent or not. The real question is how that is best achieved?

• OECD evidence demonstrates average consolidations from fiscal deficits of 7% to 1%, in comparison to Scotland’s anticipated starting point of 5.9% to a target of less than 3%.

• In general, small advanced economies pursue policies of more prudently managed debt and deficits than larger countries.

• Small advanced economies tend to respond (by necessity) more quickly and effectively to economic shocks than larger economies.

• Scotland should benchmark itself against the small advanced economies it wishes to emulate in its fiscal policies and governance, rather than against the UK which is not a prudent or successful example.

• Scotland should also learn the lessons of both international examples and recent UK policy history by tending carefully to the impact of any deficit reduction on growth performance. Scotland should explicitly reject the austerity model pursued by the UK in recent years. Scotland needs to focus on both the real economy, and putting finances on a sustainable footing, as dual fiscal goals.

• IMF evidence suggests that a gradual pace of fiscal adjustment is only credible if embedded in a medium term strategy buttressed by strong budget institutions.

B7.1 Decisions about the scale and pace of moving to a sustainable deficit position in Scotland will be shaped by both economic and political considerations. But irrespective of the fiscal policy choices made, it is vital that a robust institutional framework is established to support the journey to sustainable public finances and on-going financial management. Otherwise there is a high risk that the desired fiscal outcomes will not be achieved, or will do so in a way that causes unwarranted economic, financial or social stress.

B7.2 The design of these fiscal institutions is a central part of the process. The development of a robust process for financial decision-making is a strategic priority, central to achieving the desired fiscal outcomes for Scotland.

B7.3 This section begins by looking at definitions of fiscal sustainability to calibrate the steps a small country like Scotland will need to deliver to reach a sustainable position. It next looks at the international experience of deficit reduction: how have they been achieved, what is
the economic and fiscal impact, and what are the common characteristics of successful fiscal sustainability transitions.

B7.4 There is specific focus on the extent to which fiscal institutions have been supportive of the success of these efforts. The analysis is informed by a series of small country case studies and examples. It identifies a series of insights and implications for Scotland.

B7.5 At the outset, given the analysis in the chapters above, what is clear from the international examples is that Scotland’s position is relatively better in the round than many of the countries that have faced fiscal challenges, especially on debt. Scotland’s fiscal starting point is relatively challenging, but improving Scotland’s fiscal position is a proposition that is fundable, and entirely achievable without continued austerity. It should also be noted that achieving the economic growth objectives set out in Part A would accelerate the process.

B7.6 Following the best governance and policy approach of the most successful benchmark countries would support Scotland’s transition to a model of sustainable economic growth.

B7.7 The imperative to do this is real, and we judge the risks of maintaining the current approach within the UK to be very significant and potentially very damaging. It is perhaps because the analysis we have provided above has not yet been considered by so many critics of the Scottish position that the debate thus far has been badly framed, locked in and narrowly considered.

The Performance of Small Advanced Economies

B7.8 What is a sustainable level of debt to serve as a threshold? It makes sense to think about fiscal sustainability in terms of stabilising public debt level at some threshold (given the prevailing long term outlook for GDP growth, interest rates, demographics, and so on).

B7.9 For practical purposes, various guidelines are used to define fiscal sustainability – based on the international experience. The IMF, for example, has a working definition of fiscal sustainability: the cyclically adjusted primary balance that would stabilise debt/GDP ratios at less than 60%, given assumptions with respect to the structural fiscal pressures of an aging population, as well as assumption on growth rates, interest rates, and so on. Similarly, the OECD notes that economic costs begin to emerge when gross public debt rises above 70-90% of GDP in developed countries; and for Eurozone members the prudent debt level is estimated to be 50-70% (because of the absence of independent monetary policy flexibility to respond to shocks).

B7.10 High debt levels impose a range of costs, including higher interest rates, the crowding out of private sector activity, elevated levels of uncertainty, as well as reducing the ability of the government to respond appropriately to a shock through fiscal stimulus measures (which will increase the severity and length of a recession).
B7.11 In sum, public debt levels of below 60% of GDP are a broadly accepted definition of sustainability. For example, this is reflected in the EU’s Growth & Stability Pact fiscal thresholds: 60% debt and 3% deficit. Its successor, the European Fiscal Compact, specifies limits of 60% debt and 0.5% deficit as measured across the cycle.

B7.12 Indeed, developed country governments have shown an aversion to running debt at higher levels. This is particularly so for small advanced economies, suggesting that the sustainable (or desirable) level of public debt, and the size of the fiscal deficit, is lower for small advanced economies than for larger economies. The following figures show that small advanced economies have consistently run small deficits (or surpluses) over the past decades and tend to have relatively low levels of public debt.

Figure 7-1 – Small advanced economies tend to run relatively small fiscal deficits, or surpluses. Note that the UK has a relatively large fiscal deficit.

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations
Figure 7-2 – Structural fiscal balances also tend to be stronger in small advanced economies

General government structural balance, % of potential GDP, 2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-3 – Small economies have consistently run stronger fiscal balances over the past 20 years, including through the financial crisis period

General government net lending, % of GDP, 1995-2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations
Figure 7-4 – The same strong fiscal performance by small advanced economies is also evident on the structural fiscal balance

General government structural balance, % of potential GDP, 1995-2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-5 – Small advanced economies tend to have lower levels of public debt than larger economies

General government gross debt, % of GDP, 2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations
Figure 7-6 – Small advanced economies have kept their levels of gross debt at more stable levels

**General government gross debt, % of GDP, 1995-2016**

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-7 – The same strong small economy picture is also seen in terms of net public debt positions

**General government net debt, % of GDP, 2016**

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations
Figure 7-8 – The small economy net debt profile over the past two decades has been more stable; it has trended up in large advanced economies

General government net debt, % of GDP, 1995-2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

B7.13 Small economies also tend to respond rapidly to economic shocks that cause a weakening of the fiscal position (New Zealand, Ireland and Finland are some recent examples, see Figure 7-9, Figure 7-10, Figure 7-11, and Figure 7-13).

B7.14 And in general, the structural fiscal balances in these countries have improved more markedly after the fiscal shock of the global financial crisis; fiscal consolidation has been a key feature of the post-crisis policy approach in small advanced economies. These examples also show how small economies have responded to fiscal deficits greater than that faced by Scotland.
Figure 7-9 – New Zealand has consistently exerted fiscal discipline since the early 1990s, and responded quickly to the shock from the financial crisis

Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

Figure 7-10 – Finland responded aggressively to the fiscal crisis of the early 1990s; it is currently working to exert fiscal control in a low growth environment

Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations
**Figure 7-11** – Sweden addressed a 10%+ fiscal deficit in the early 1990s, through tight expenditure control, robust GDP growth & strong fiscal institutions.

Net lending, % of GDP, 1985-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>-6.2</td>
</tr>
<tr>
<td>1992</td>
<td>-3.4</td>
</tr>
<tr>
<td>1993</td>
<td>-0.5</td>
</tr>
<tr>
<td>1994</td>
<td>1.2</td>
</tr>
<tr>
<td>1995</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Structural balance, % of GDP, 1993-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Structural Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>-2.3</td>
</tr>
<tr>
<td>1994</td>
<td>-1.2</td>
</tr>
<tr>
<td>1995</td>
<td>0.1</td>
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<tr>
<td>1996</td>
<td>1.2</td>
</tr>
<tr>
<td>1997</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Gross public debt, % of GDP, 1993 - 2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>70%</td>
</tr>
<tr>
<td>1994</td>
<td>65%</td>
</tr>
<tr>
<td>1995</td>
<td>60%</td>
</tr>
<tr>
<td>1996</td>
<td>55%</td>
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<tr>
<td>1997</td>
<td>50%</td>
</tr>
</tbody>
</table>

General government expenditure, % of GDP, 1985-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>General Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>20%</td>
</tr>
<tr>
<td>1994</td>
<td>22%</td>
</tr>
<tr>
<td>1995</td>
<td>24%</td>
</tr>
<tr>
<td>1996</td>
<td>26%</td>
</tr>
<tr>
<td>1997</td>
<td>28%</td>
</tr>
</tbody>
</table>

**Source:** IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

**Figure 7-12** – Ireland’s strong growth has helped fiscally, although it led to structural loosening prior to the crisis. The post-crisis response was rapid.

Net lending, % of GDP, 1995-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>-5.2</td>
</tr>
<tr>
<td>1996</td>
<td>0.1</td>
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<tr>
<td>1997</td>
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</tr>
<tr>
<td>1998</td>
<td>3.4</td>
</tr>
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<td>1999</td>
<td>5.6</td>
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Structural balance, % of GDP, 1999-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Structural Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>-2.3</td>
</tr>
<tr>
<td>2000</td>
<td>-1.2</td>
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<td>2002</td>
<td>1.2</td>
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<tr>
<td>2003</td>
<td>3.4</td>
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</table>

Gross public debt, % of GDP, 1995-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>70%</td>
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<td>65%</td>
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<tr>
<td>1999</td>
<td>50%</td>
</tr>
</tbody>
</table>

General government expenditure, % of GDP, 1995-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>General Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
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<td>24%</td>
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<tr>
<td>1998</td>
<td>26%</td>
</tr>
<tr>
<td>1999</td>
<td>28%</td>
</tr>
</tbody>
</table>

**Source:** IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations
B7.15 Overall, small economies tend to be a more prudent in their approach to fiscal policy. A sustainable (desirable) level of public debt is lower in small economies than in large ones. The immediate implication for Scotland is that it should aim to be more prudent than the UK and that it has the opportunity to do this. Hence the debt targets identified in chapters 10 and 14.
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Figure 7-14 – Several successful small advanced economies have high levels of government spending, although there is a wide distribution

General government expenditure, % of GDP, 2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-15 – Fiscal policy needs to respond the higher level of growth variation that in small advanced economies, albeit on a plane of higher general performance

Standard deviation of real GDP growth, %, 1990-2016

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations
International Examples

B7.16 This section considers international experiences of substantial fiscal consolidations. These are defined differently in different studies, but a common definition is an improvement in the structural fiscal balance of more than 1.5% in a year, sustained for at least three years. There have been many examples of such consolidations, with a further increase in the number of fiscal consolidations over the past several years. And there are many instances of fiscal consolidations of a similar or indeed on a much larger scale to that facing Scotland.

B7.17 In a recent OECD study the average improvement was from a fiscal deficit of 7% of GDP to a fiscal deficit of 1% of GDP.

B7.18 This movement of 6 per cent is twice the scale of what is required to get Scotland from the actual inherited position that we anticipate (from just under 6% to under 3%).

Figure 7-16 – Many small advanced economies experienced a marked slow-down in growth rates during the global financial crisis

Real GDP growth change, % (difference between 2007 and 2009; between 2009 and 2011)

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations
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Figure 7-17 – This contributed a substantial weakening in fiscal positions across advanced economies, with many still recovering (1/2)

Change in government net lending, % of GDP (difference between 2007 and 2009; between 2009 and 2015)

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-18 – This contributed to a substantial fiscal weakening in fiscal positions across advanced economies, with many still recovering (2/2)

Change in government structural fiscal balance, % of potential GDP (difference between 2007 and 2009; between 2009 and 2015)

Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Characteristics of deficit reduction programmes

B7.19 There are a few stylised facts that are instructive. With respect to the economic impact the consensus is that there is a significant multiplier effect from a fiscal consolidation; tightening
has a negative effect on the economy as the fiscal impulse reduces or turns negative. In bad times these multipliers can be quite large, and larger than in good times, which is why the economic impact of the process was under-estimated in several crisis countries. Scotland will need to be careful to tend to both the real economy and deficit reduction at the same time.

B7.20 However, this is not the universal experience – and there are periods of economic expansion at the same time as fiscal consolidation. The key factor in explaining these episodes is strong sources of external demand (and continued expectations thereof). Maintaining growth during periods of fiscal tightening requires a strong contribution from a key growth engine, which for small economies is almost certainly the export sector. This can be seen clearly in the post-crisis experience of countries such as Ireland and New Zealand which experienced relatively strong export growth (from currency depreciation coupled with cost restraints) over the relevant periods – supplemented by strong migration and inward investment.

B7.21 Roberto Perotti provides case studies of four small countries which undertook programme to improve their fiscal positions in the 1990s (Ireland, Denmark, Finland and Sweden). The key finding is that the countries that could sustain fiscal improvement were those that benefited from strong external demand; Denmark had relied on other sources of internal demand and was not able to sustain growth.

B7.22 This places the imperative of export led growth policies for Scotland to the forefront of thinking, as a key part of a strong, high quality economic strategy as set out in Part A.

B7.23 For a country, like Scotland the general credibility effect associated with efforts to improve the public finances is likely to be valuable. If a growth-oriented economic strategy is implemented at the same time then this will offset some of the economic effects of fiscal control.

B7.24 In general, for small economies returning to fiscal sustainability is a key priority. The challenge is to manage this process as effectively as possible. This is clearly a balancing act, given the economic impact of fiscal control and the different challenges and opportunities facing a newly independent country.

B7.25 The pace of the process should also have a clear view on overall timelines.

B7.26 Successful improvements in public finances have generally been structured with an emphasis on spending control relative to revenue growth. The empirical work consistently finds that deficit reductions that are successful, sustainable and have a modest impact on GDP, employment and investment tend to focus on spending control policies that are clear. The reason is to gain credibility in the markets for fiscal discipline, enough to secure investment spending and growth.

B7.27 Another contribution to improvements in the public finances is strong growth. However, deficit reduction requires more than growing out of a challenging fiscal situation; action is required.
B7.28 The IMF summarises the consensus on fiscal consolidation, noting that, “A gradual pace of fiscal adjustment will be credible only if embedded in a medium-term fiscal consolidation strategy buttressed by strong budget institutions. Other growth-enhancing measures, such as structural reforms, will be important to improve growth potential in the medium term and to help reduce the debt ratio durably. Where fiscal accounts are weaker and sovereign interest rates higher, the pace of adjustment will have to be more ambitious, bearing in mind the limits to social and political cohesion beyond which fiscal adjustment can be counterproductive.” (Abbas et al. (2013)).
B8 SUPPORTING INSTITUTIONS: EVIDENCE FROM SMALL ADVANCED ECONOMIES

- The structure and design of fiscal policy and governance matters for both sustainable public finances and economic growth. We look to the evidence of successful small advanced economies.
- There are three supporting institutions that contribute: credible rules, targets and reporting; disciplined budget allocation processes; a structured approach to the government balance sheet.
- International evidence demonstrates that such institutions with respect for rules and targets can anchor expectations and build credibility. This is critical for creating sustainable and lowest cost funding of public borrowing.
- International examples are outlined in this chapter. Long term fiscal targets are recommended with clear guiding principles. A path for fiscal sustainability should be laid out clearly. Clear reporting and transparent accountability arrangements should be put in place.

B8.1 The sustainability of fiscal consolidation – and the extent to which it supports rather than hinders economic growth and does not compromise delivery of public goods and services – depends greatly on the way in which it is designed and structured and the values that drive any government or parliament. A strong set of fiscal institutions will support the consolidation, add credibility to the programme accelerating its impact, and allows for ongoing fiscal discipline to be exerted.

B8.2 The international evidence shows clearly that the existence of strong institutions increases the probability of improvements in the fiscal position that can be sustained over time. Indeed, in many small countries, these institutions were established precisely to support such improvements (such as New Zealand, Australia, and Sweden).

B8.3 There are three types of supporting institutions that contribute to successful fiscal management:

1. credible aggregate fiscal rules, targets and reporting;
2. a disciplined budgetary allocation process; and
3. a structured approach to managing the government balance sheet.

B8.4 The OECD and IMF both consistently note that institutions with respect for fiscal rules and targets can help to anchor expectations, and build credibility. This is helpful for the domestic political economy, as well as in terms of capital market confidence. Countries that have credible spending or budget balance rules are more likely to stabilise debt and deficits.
B8.5 The benefits of deficit reduction can be eroded over time if there are not processes and institutions that can exert a degree of control and discipline to ensure on-going fiscal decision-making. It is here that a debt target, being a stock and therefore persistent, not an annual deficit flow, comes into its own. Once the sense of urgency or threat of a financial sanction passes because next year’s deficit is a new deficit, the risk is that the government is unable to hold the line in terms of rigorous fiscal decision-making. It is not just a matter of controlling spending or raising revenues, but a way of sustaining this controlled decision-making over time. Ministerial commitment is a necessary but not sufficient condition; supporting institutions and processes are central to ensuring that improved fiscal outcomes are sustained.

B8.6 Countries with stronger budgetary processes were more successful in reducing debt. It is notable that countries that implemented stronger budget processes also had a better fiscal experience through the crisis (such as New Zealand). They could control spending growth more readily and restore fiscal sustainability. The European Commission also reports evidence that superior budgetary processes are associated with greater likelihood of successful improvements.

B8.7 A targeted approach is best to ensure a controlled fiscal improvement, for example through effective spending reviews. This helps contain future spending growth pressures. The premium is on securing productivity improvements in key categories of public spending so that the government can do more with the same level of resource.

Implications for Scotland

B8.8 There are two insights from this international experience that have direct implications for Scotland.

B8.9 First, a sustainable fiscal position is a strategic priority for small advanced economies. Fiscal sustainability matters more in small economies than in large countries; eventually large country fiscal positions need to be corrected, but they have a longer period in which to do so. For Scotland, as in other small countries, the willingness of capital markets to finance a fiscal deficit is a primary consideration. To secure that, Scotland will need to invest in building market credibility.

B8.10 Other small countries have achieved a return to fiscal sustainability (even in weak economic conditions) from a more challenging starting position than that facing Scotland. Indeed the Scottish ‘go-ahead’ debt position is far better than most countries and the deficit position, while challenging, is less stark than faced by many OECD countries at the start of such a process.

B8.11 Second, the history of achieving a position that is sustained and effective is that there are strong supporting fiscal institutions.

B8.12 Achieving an effective fiscal position is not simply a matter of making choices on spending and revenue. It is largely about having the institutional architecture that credibly commits
the government to a sustainable fiscal policy path, and that provides a robust and transparent basis on which to make choices. Because a substantial amount of the programme will likely come through controlling growth in the spending channel, it is crucially important to have secure and robust budgetary processes to guide these spending controls.

B8.13 Overall, fiscal institutions are central to the process of Scotland delivering a substantial, sustained improvement in its fiscal position. These institutions are also essential in steady state to ensure that the gains are locked in.

B8.14 These realities will place pressures on Scotland’s fiscal decision-making: delivering a far-reaching reform in an economically coherent way and which does not compromise the underlying quality of public goods and services will be challenging but necessary under any constitutional position.

B8.15 It is in this context that we examined the international experience to understand the contribution that fiscal institutions can make, and the nature of a best practice system. The next three sections consider three key types of institution in more detail, to develop specific insights and guidance for Scotland: (i) aggregate fiscal institutions; (ii) budgetary processes; and (iii) government balance sheet management.

**Aggregate Fiscal Institutions**

B8.16 The first type of institution considered is the establishment of aggregate fiscal institutions to support the immediate process of fiscal improvement, and then to support an on-going exertion of fiscal control and discipline. This section provides a more detailed definition of these institutions; describes the international experience with respect to fiscal institutions, with a focus on small countries, and the associated evidence of their impact on fiscal outcomes; and draws out key implications for Scotland.

B8.17 Over the past few decades since the late 1980s, there has been a pronounced trend for developed economies to establish explicit fiscal frameworks to guide the government’s overall fiscal policy approach. This was part of a broader movement of economic and public sector reform across many developed countries.

B8.18 But a key motivation for establishing these institutions was the common need to support fiscal consolidations, prevent them being needed again, and promote an understanding of the need to deliberately lean against the systematic tendency towards excessive debt accumulation. Debt enables the cost of current spending and investment to be shifted into the future. There is a large conceptual literature showing that governments face political incentives to defer spending cuts or tax increases, and to run fiscal deficits. This tendency led to steady increases in public debt levels across developed countries from the 1960s.

B8.19 Fiscal rules and institutions provide a discipline on these incentives to accumulate public debt, and to push fiscal costs into the future. They provide an overall trajectory for the process: what is the current state, what is the medium term desired steady state, and what
is the trajectory to get there? To the extent that this is done in a credible, best practice manner, it provides confidence in sustained good fiscal management. There is strong evidence that these institutions do make a difference for fiscal outcomes.

Defining Fiscal Institutions

B8.20 Fiscal institutions are intended to strengthen control over the fiscal position, in terms of the fiscal deficit and the accumulated stock of public debt. There are several core elements of a best practice set of fiscal institutions.

B8.21 The central element is to explicitly specify the medium term fiscal rules or targets (generally in terms of public debt, the fiscal deficit, and sometimes additional fiscal outcome measures) as well as the fiscal principles that will guide the fiscal path. This is accompanied by institutions designed to promote fiscal transparency (how often public reporting on the fiscal position and outlook is to be prepared), accountability mechanisms, independent economic and fiscal forecasting, and so on.

B8.22 This discussion describes these elements, using country case studies, and provides a summary of the consensus on what good practice looks like.

(a) Fiscal Rules and Targets

B8.23 At the core of fiscal institutions are numerical targets or guidelines. The IMF’s Fiscal Rules Dataset shows that these fiscal rules focus largely on fiscal deficits and public debt, although some countries also specify rules and guidelines for the growth rate of spending and revenues. These fiscal rules emerged in the early 1990s, and have become increasingly widespread over the past 25 years (the IMF report that about 80 countries now have formal fiscal rules). Figure 8-1 (below) describes aspects of fiscal rules for selected small advanced economies.

B8.24 The IMF notes three key design principles for fiscal rules: a clear link to fiscal sustainability; flexibility in the application of the rule, so that the fiscal position can respond appropriately to shocks; and credible institutional sanctions for missing fiscal targets. The fiscal rules observed across most developed countries – and the case study countries discussed below – follow these design features. A key current debate is on how best to balance the need for fiscal stability against the importance of flexibility in a challenging economic environment.

B8.25 The international experience is that countries that have such fiscal rules and guidelines tend to generate stronger fiscal outcomes than those without. There is good evidence that these institutions helped to stop the increase in debt accumulation in many countries from the early 1990s. Once that happens, financing for future developments tends to flow.

B8.26 Another key contribution of fiscal institutions is to constrain the tendency towards 'pro-cyclical' fiscal policy - the tendency to tighten fiscal policy in bad economic times and to loosen fiscal policy in good times. This can generate economic costs, by amplifying the
magnitude of the business cycle, and often leads to debt accumulation over time (as fiscal policy is loosened more in good times than it is tightened in bad times). This tendency was observed in several countries in the decade before the crisis: for example, in New Zealand, Ireland and the UK. Fiscal institutions that extend the focus of decision-making across the business cycle can help to constrain this behaviour.

B8.27 There are two broad approaches to designing fiscal rules or targets: principles-based or a hard numerical target. In the ‘principles-based’ approach, the guiding principles for the conduct of fiscal policy are written into legislation – and it is then for the government of the day to specify exactly what this means in terms of the specific targets. Examples of this approach include New Zealand’s Public Finance Act and Australia’s (legislative) Charter of Budget Honesty.

B8.28 For example, New Zealand’s Public Finance Act specifies the requirements of responsible fiscal management. Governments are required to specify a fiscal strategy that is consistent with several principles: to reduce total debt to prudent levels and achieve and maintain levels of total net worth so as to provide a buffer against adverse economic shocks; to ensure that on average total operating expenses do not exceed total operating revenues; to take into account the impact on monetary policy; to prudently manage the fiscal risks facing government; to have regard for present and future generations; and to ensure the nation’s resources are managed effectively and efficiently.

B8.29 This allows for a degree of political flexibility, as governments can set the direction in a way that they think is appropriate. A key part of the value is to be transparent about the target and the objectives of fiscal policy. It means that the target is owned by the government, and can be adjusted to the prevailing economic context. For example, fiscal targets were adjusted after the crisis to reflect the more negative outlook. Of course, for such a system to work effectively, these rules need to be supported by political culture and norms to constrain inappropriate departures from sustainable fiscal policy. This should be done in a way that commands bipartisan support, so there are not major swings in fiscal policy approach.

B8.30 In this sense, these fiscal institutions are similar to the standard approach to monetary policy – in which the government specifies an inflation target (or similar objective) for the central bank in a public, transparent way, but is able to revise this target if it deems it appropriate.

B8.31 The second approach is a ‘rules-based’ approach of the type in the EU’s Growth & Stability Pact. These specify a debt limit of 60% of GDP and a deficit limit of 3% of GDP. There are some provisions for flexibility, particularly in the event of exogenous events, which have increasingly been used since the crisis (although large countries such as Germany, France and Italy are more likely to receive this flexibility than small countries).

B8.32 The second design issue is how to specify the substance of these fiscal targets. Figure 8-1 has a listing of fiscal rules from selected small advanced economies.
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Figure 8.1 – Fiscal rules in selected small advanced economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Over time (60–110)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>Expenditure rule implies that real growth in public expenditures cannot exceed potential GDP growth. The Budget Act which came into force in 2014 introduces expenditure ceilings. The government targets a balanced structural budget by 2020. The annual structural public balance must not exceed a deficit of a ¼ per cent of GDP at the time of the budget proposal for a given year unless extraordinary circumstances are present. Moreover, an automatic correction mechanism is activated in case of a significant projected deviation. EU rules.</td>
</tr>
<tr>
<td>Finland</td>
<td>There is a political commitment to achieve a substantial reduction in the debt-GDP ratio by the end of the parliamentary term. Moreover, the government is committed to adjust if the debt/GDP ratio is not shrinking or if the deficit stands above 1% of GDP. EU rules.</td>
</tr>
<tr>
<td>Israel</td>
<td>Public debt target of 60% of GDP. Spending growth is a function of achieving this target, with formal expenditure growth limits specified.</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Since 2004, public debt is to be kept at a level substantially below limits foreseen in the MIP. On spending, since 2010, the target is to bring expenditure growth back to the medium-term growth prospects once the counter-cyclical response to the crisis has been phased out. Under the “fiscal compact” signed March 1, 2012, the government commits to adopt a structural budget balance rule in its constitution as well as an automatic correction mechanism by 2014. EU rules.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Since 1994, real expenditure ceilings are specified for most classes of spending: EU fiscal balance and deficit rules.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Maintaining rising operating surpluses (before gains and losses) over the forecast period so that cash surpluses are generated and net government debt begins to reduce in dollar terms; reducing net government debt to around 20 per cent of GDP in 2020 and, in the medium term, reducing net debt to within a range of 0 per cent to 20 per cent of GDP.</td>
</tr>
<tr>
<td>Norway</td>
<td>Since 2001, the non-oil structural deficit of the central government should reflect the expected return of the Government Pension Fund Global (GPFG), which is estimated to be 4%.</td>
</tr>
<tr>
<td>Sweden</td>
<td>Since 2000, a 1% fiscal surplus target over the cycle (measured by the average balance since the adoption of the target, a seven-year moving average, and the annual structural balance) expenditure growth targets as well as the EU rules.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Switzerland: Since 2003, the structural budget has to be balanced (one year ahead spending has to equal expected revenues, adjusted for the cycle). Any deviations included in a “compensation account”, that needs to be corrected when it exceeds 6% of GDP.</td>
</tr>
</tbody>
</table>

Source: IMF Fiscal Rules Dataset; European Commission Fiscal Rules Database

Debt Rule

B8.33 First, consider the debt rule. For small economies specifically, these debt rules are specified on the basis that high levels of debt impose economic costs (e.g., higher risk premiums, which are damaging to investment), expose the economy to additional risks, and compromise growth and the ability to respond to cyclical or structural shocks. The greater volatility that small economies can experience also strengthens the case for fiscal conservatism – and setting the debt rule with a safety zone that allows shocks to be absorbed without breaching debt limits.

B8.34 The rule should reflect a level that is sustainable, recognising the potential for volatility as well as structural fiscal trends such as the fiscal costs of an aging population. For many small advanced economies, the national debt limits are adopted from membership in the EU (60% debt), although countries will often include additional guidelines and rules. For small countries outside the EU: New Zealand has a 20% net debt target and Israel has a 60% gross debt target.

B8.35 The OECD notes that debt targets should be designed to avoid overshooting the threshold in the case of an economic or other shock. Their model estimates around 15% for advanced economies: suggesting that for a debt ceiling of 60%, the debt target should be set at 50% of GDP or less.

Deficit Rule

B8.36 The fiscal deficit target should be set in a manner consistent with stabilising the debt level at or below the debt limit, while preserving a measure of flexibility to allow automatic
stabilisers to work. These deficit rules are specified in several ways: current balance (or including capital expenditure); the primary balance (excluding interest); or the structural/cyclically adjusted balance. And the deficit target can be specified at a point in time, or over a period (most frequently, over the business cycle). It can also be forward looking (based on an expectation of the current fiscal path) or backward looking (outcomes over the past several years); forward-looking rules can be more flexible (making subsequent consolidations less painful), whereas backward looking rules provide a tighter constraint and added credibility (particularly where the government has a deficit history).

B8.37 In general, deficit rules across the small advanced economies group adopt a business cycle perspective to the deficit target. Beyond this, there is significant variation in the specific design features. One consideration that has become increasingly apparent is that the design of the fiscal framework needs to be consistent with the monetary policy framework. Where independent monetary policy is constrained (for example, because of Eurozone membership, or because of pegged exchange rate), fiscal policy will undertake more of the stabilisation activity. The debt and deficit targets should reflect this.

B8.38 The other notable feature in many small advanced economies is the role of spending growth rules or limits, which are often framed in a way to ensure compliance with the overall fiscal rules and targets.

(b) Fiscal Transparency, Reporting, Accountability

B8.39 A second key element of fiscal institutions relates to the transparency of reporting requirements. This has been an area of significant progress over the past two decades. The standard definition of fiscal transparency is: “Openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities – whether undertaken inside or outside the government sector – so that the electorate and financial markets can accurately assess the government’s financial position and the true costs and benefits of government activities, including their present and future economic and social implication.” (Kopits and Craig (1998))

B8.40 There is a strong evidence base, using multiple datasets and methodological approaches, on the positive relationship between fiscal transparency and fiscal outcomes, even in the presence of strong fiscal rules or targets. The IMF’s Fiscal Transparency Database documents a substantial improvement in fiscal transparency over the past two decades. This is associated with substantial and sustained improvements in fiscal outcomes in the aggregate. And within countries, the establishment of high quality fiscal transparency initiatives leads to improved fiscal outcomes over time.

B8.41 There is also evidence that fiscal transparency helps deliver high quality fiscal outcomes. For example, it prevents (or makes it more difficult) a government from hitting fiscal targets...
through accounting tricks – and raises the discipline to ensure that the fiscal consolidation is real.

B8.42 The two key transmission mechanisms between fiscal transparency and stronger fiscal outcomes are higher-quality fiscal decision-making because there is better quality fiscal and economic information (and less chance of being surprised by fiscal risks, because the coverage will be more comprehensive); as well as added fiscal credibility, which helps with credit ratings, lowering the interest rates on government borrowing (and hence, in many cases, private sector borrowing). This will be the case also for Scotland while it establishes initial credibility with respect to its commitment to fiscal discipline.

B8.43 The IMF’s Fiscal Transparency Database contains a listing of the various dimensions of fiscal transparency, and several researchers have constructed various measures of fiscal transparency (based on both IMF and OECD data). Small economies tend to rank well on these various measures, which is consistent with their general strong performance on measures of institutional quality, lack of corruption, and so on.

B8.44 Countries such as Australia and New Zealand provide good examples of fiscal transparency. New Zealand’s Public Finance Act, for example, requires the Government to clearly state its fiscal policy objectives and the relationship between their policies and the principles of responsible fiscal management. Australia’s Charter of Budget Honesty, passed in 1998, requires the Government to set out principles and requirements that guide the Government’s management of fiscal policy (for example, to state its medium-term fiscal strategy, along with its shorter-term fiscal objectives and targets, and the accompanying economic and fiscal assumptions. It also has guidelines for costing policy proposals.
New Zealand’s Public Finance Act

New Zealand’s fiscal plans and objectives are presented in two key documents: The Fiscal Strategy Report and The Budget Policy Statement.

The Fiscal Strategy Report (FSR) is tabled in Parliament by the Finance Minister in advance of the budget. It states long-term (10 year) objectives for fiscal policy, including for the fiscal balance, operating expenses and revenues, the level of total debt and net worth; and explains how these long-term objectives accord with the principles of responsible fiscal management. If there is a deviation, this needs to be explained. The FSR also includes a statement of short-term (3 year) intentions on these variables (3 or more years); the consistency of short-term intentions with the principles of responsible fiscal management and long-term objectives, needs to be explained (and if there is deviation, the nature of the plan for return).

The Budget Policy Statement is normally tabled in Parliament in December by the Finance Minister, in conjunction with the December Economic and Fiscal Update. It focuses on the next budget (normally tabled in May). It is required to state the broad strategic priorities for the forthcoming budget including overarching policy goals, policy areas and consistency with the most recent short-term fiscal intentions. It also needs to explain any changes in the long-term fiscal objectives, or short-term fiscal intentions, and their relationship to the principles of responsible fiscal management. The goal is to avoid ‘budget surprises’ and allow time for debate before the Budget document is tabled.

Alongside this reporting, the Government is required to prepare regular economic and fiscal updates. There is the Budget Economic & Fiscal Update, a mid-year December Economic & Fiscal Update, as well as a Pre-Election Economic & fiscal Update (released around a month prior to a general election).

(c) Independent Fiscal Institutions

B8.45 Another form of external scrutiny is through independent fiscal organisations, such as fiscal commissions or fiscal advisory councils. There has been a rapid increase in these independent institutions, which are established by government to provide an additional check on fiscal policy decision-making (and indeed are now required by the IMF and EU Commission before any official loan programmes can be agreed). This is partly a response to concerns that many governments had made strategic policy mistakes (sometimes self-interested), and that additional institutional ‘checks and balances’ were required to ensure disciplined fiscal policy decision-making (for example, Ireland and the UK before the crisis). However, in countries such as The Netherlands, Sweden and Denmark, these agencies have been around for decades.

B8.46 Fiscal commissions are designed in many ways, often reflecting the specifics of local institutional and political context. Some agencies provide advice to the government on fiscal policy settings (Denmark, Sweden); others have a role in passing public judgement on the fiscal policy approach, such as whether it is consistent with meeting fiscal targets (Ireland); and some are involved directly in preparing economic and fiscal forecasts (The
Netherlands, the UK). Designed well, these can add to the credibility of fiscal policy, as well as the overall quality of the debate around fiscal policy.

B8.47 In 2013, the Fiscal Commission Working Group in Scotland recommended the establishment of a Fiscal Commission in Scotland. They noted that such a Commission would contribute to increasing the quality of public debate, increasing the credibility of fiscal policy by policing the extent to which fiscal policy settings were consistent with fiscal sustainability (and stated fiscal targets). A Scottish Fiscal Commission was created in 2014, but it has been restricted to forecasting the revenues from the four devolved taxes without commentary on budget sustainability.

B8.48 The evidence on these Commissions is mixed. They are generally seen as a useful addition, particularly when they include independent, respected experts. However, international reviews of these independent fiscal institutions consistently warn that they should not be regarded as ‘silver bullets’ – and it is not clear that they have led to significant changes in fiscal decision-making (over and above fiscal targets, broader fiscal transparency, and other sources of political and market discipline). They are better seen as a complement to existing institutions.

B8.49 Indeed, independent fiscal councils often struggle to compete with political realities. For example, Ireland’s Fiscal Advisory Council, established in 2011, and comprising five academic economists (with a small secretariat), has a mandate to assess the macroeconomic and budgetary forecasts produced by the Department of Finance; to assess whether the fiscal stance of the Government is conducive to prudent economic and budgetary management with reference to the EU Stability and Growth Pact; and to monitor and assess compliance with the budgetary rule as set out in the Fiscal Responsibility Act.

B8.50 However, although the Council has good people and does good work, its statements of concern about government budgets seem to have had relatively limited impact on the fiscal decision-making process. Over the recent past, the Council has consistently pointed to the risks of overly loose fiscal policy, with which the government has chosen to disagree.

B8.51 One specific function of independent agencies that is also relevant to Scotland is the preparation of the economic and fiscal forecasts used in the Government’s budgeting process (and to an extent for the costing of policies announced, including in election season).

B8.52 There is a well-documented tendency of systematic bias towards over-optimism in fiscal and economic forecasting, with consequent deficit bias. This is particularly true in good times, and when the fiscal position is closer to breaching the threshold (e.g. the 3% deficit limit in the EU). This leads to a need to subsequently make painful adjustments. In 24 countries, Jeffrey Frankel identifies a 1% bias in fiscal forecasting at a two-year horizon and a 2% bias at a three-year horizon (higher again in the 17 Euro-economies). If governments set policy on flawed forecasts, otherwise strong fiscal rules and budget processes may not be sufficient to generate strong fiscal outcomes.
B8.53 There are different models for building independence in forecasting to reduce this systematic basis. For example, New Zealand does this internally in the Treasury, which is a credible forecaster and is fully (operationally) independent of government. It also has established an external review process of these forecasts, to ensure that it is best practice. Many Finance Ministries rely on independent scrutiny of the quality of fiscal forecasting by technical experts, as well as markets and other researchers.

B8.54 Another model is to establish an independent economic and fiscal forecasting agency; such as the Central Planning Bureau in The Netherlands (established in 1945) or the Office of Budget Responsibility in the UK (established in 2010).

B8.55 The UK’s OBR was established because of concern about optimism bias (and political influence) with respect to the UK’s fiscal forecasts and the way in which the business cycle was defined, which allowed for a significant weakening in the UK’s fiscal position prior to the crisis. The OBR has four main responsibilities: to produce (five year) forecasts for the economy and public finances (contained in its Economic and Fiscal Outlook published twice yearly); to judge progress by the government towards its fiscal targets and the likelihood that they will be achieved; to assess the long-term sustainability of the public finances; and to scrutinise Treasury’s costing of Budget measures. But it may not comment on the likely effectiveness of those policies.

B8.56 The CPB in the Netherlands has a wider role, also conducting simulation of the Government’s fiscal policies, their likely impacts and costs, and to consider the advantages of various alternatives in discussion with Cabinet members in the Social and Economic Council.

(d) Long-term Fiscal Forecasts

B8.57 Longer range forecasts have become more widespread over the past decade or so as more countries have recognised the potential fiscal impact of an aging population (such as old age pensions, health care spending). The expected spending and tax profile over the next decade associated with these structural trends may have an impact on the way in which fiscal policy should be approached today. For example, should governments run fiscal surpluses to save for these future costs – rather than raise taxes or cut other spending at the time? This is a choice about well-designed fiscal policy, but is also an issue of intergenerational equity.

B8.58 Fiscal policy decisions should be informed by clear data on the likely strategic context. In New Zealand, there is now a legislative requirement to supplement existing fiscal reporting with a long-term fiscal update (a 40-year horizon) with formal projections at least every four years. The aim is to better allow fiscal policy to be adjusted smoothly over time in response to emerging fiscal pressures. Similarly, Australia’s Charter of Budget Honesty has recently been amended to include a requirement for intergenerational reporting (reflecting Australia’s exposure to the fiscal costs of an aging population). These reports have a 50-
year horizon, and are required to be prepared and published every five years. The first of these reports was released in 2002.

Given the inherent uncertainty associated with long-term forecasting, these will be heavily assumption-based (growth rates, oil prices, interest rates, and so on), and will often contain several scenarios with a range of possible fiscal outcomes.

Implications for Scotland

An independent Scotland would need to act purposefully to establish fiscal sustainability and credibility. For Scotland, there are three key elements of an approach to establishing fiscal institutions that will support a credible, effective improvement in the fiscal position. These institutions will also provide the basis for on-going strong fiscal management in a sustainable, steady state situation, once the initial phase has concluded.

(i) Long-term Fiscal Target, with Clear Guiding Fiscal Principles

The first task would be to define an overall fiscal anchor for the process, which would be guided by a definition of fiscal sustainability. As a start, this would involve a target for the public debt/GDP ratio and fiscal balance limits.

The overall anchor for fiscal policy should be defined in terms of a stable level of gross debt at or below a sustainable level. There are two points of reference from the international experience to suggest a long-term debt target for Scotland.

First, the debt limit in the EU’s Fiscal Compact (60% of GDP) is a useful starting point. Ensuring that Scotland holds to meeting this minimum standard has several advantages. It is an understandable target (for the public and by markets), it is consistent with Scotland’s aspiration for EU membership, and it is a fiscal rule that is used by many other small advanced economies in Europe. To convert this threshold into a target, it is important to recognise the fiscal and economic situation faced by small economies. Based on the OECD’s work, a ‘buffer’ of 10-15% of GDP is appropriate to ensure that this 60% threshold is not breached. As a first approximation, this suggests a fiscal target of public debt of 50% of GDP or less.

The second perspective is to look at current public debt levels of small advanced economies. The median of this group is currently 54% (with Singapore removed, because its gross debt does not reflect its underlying fiscal position), and with several countries still undertaking fiscal consolidation efforts to further reduce debt levels. This is consistent with a debt target of less than 50%. There is not much that can be gleaned from the international small country experience with fiscal rules. Most small advanced economies are subject to EU rules. Of those that are not, Singapore and Hong Kong do not have debt targets, Israel has a 60% debt target, and New Zealand has a net debt target of less than 20% of GDP.

Overall, specifying a medium-term target for debt to be stable at 50% of GDP or less is a reasonable target for Scotland. This is broadly consistent with the analysis of the Fiscal
Commission Working Group in 2013. 60% should be regarded as the upper limit or threshold that should not be exceeded. Focusing on a 50% debt target will also assist in the process of strengthening Scotland’s fiscal credibility, and it is very reachable.

B8.66 Once longer-term forecasts are made (which need not be an immediate priority), the debt target may need to be adjusted to reflect any demographic related challenges. For example, pre-funding of these future costs may be required – which may imply deliberately reducing debt now in expectation of a rising debt profile in the future as the population ages.

B8.67 In terms of the fiscal balance target, the target should be specified in a manner consistent with maintaining a debt track under 50% of GDP. This is contingent on the GDP growth rate, interest rates, as well as the desired buffer against shocks. If a 2% GDP growth rate can be sustained, then a deficit limit of around 1% of GDP may be appropriate in the longer term. If the growth rate is expected to be lower, then it may be appropriate to target fiscal balance over the business cycle. Conversely, a stronger GDP growth rate may allow for a slightly higher deficit target.

B8.68 Specifying a relatively conservative fiscal deficit target is important in providing space for counter-cyclical policy to be deployed. If a higher deficit target is specified there is limited space for additional fiscal stimulus in the event of a negative shock. It is better to be more prudent in normal times to allow for more effective counter-cyclical fiscal policy to be used in bad times. A more conservative target is also appropriate because the international experience cautions that fiscal ‘slippage’ is likely (because of the bias towards over-optimism); one response to this is to aim for a tighter fiscal balance target.

B8.69 Over time, the definition of fiscal balance should be extended to a broader balance sheet perspective (so that nothing is off-balance sheet from a budgetary perspective). This would also have the advantage of including depreciation costs, so that capital expenditure is smoothed out over time.

B8.70 Expenditure targets are not necessary as part of the long-term fiscal objective, although they may play a valuable role in providing budgetary discipline in a shorter-term sense. Figure 8-1 notes that many small advanced economies have expenditure growth rules or targets to ensure that fiscal decision-making remains consistent with overall fiscal targets. Scotland should follow this lead.

(ii) Laying Out a Clear Path for the Fiscal Recovery

B8.71 The critical challenge is moving from Scotland’s starting fiscal position to this targeting of sustainability. To anchor the process – for markets, for domestic political purposes, and for budget planning purposes – it is important to have a clear, credible fiscal trajectory planned.

B8.72 This should move with pace, aiming to achieve a sustainable fiscal position within 10 years. This timeline is necessary to ensure consistency with EU fiscal rules, as well as recognising the limits with financing fiscal deficits of anywhere close to the current level.
This path should be clearly laid out and progress reported. The pace of the fiscal consolidation should be measured through the deficit/GDP ratio, moving from the starting point to a stable level of under 3% of GDP initially and then in a steady state maintaining the Debt/GDP ratio below 50% and balancing the deficit over the course of any cycle or with a relatively small deficit level running lower than GDP growth over the cycle.

**Clear Reporting, Transparency, Accountability Arrangements**

An important way of establishing the credibility of this process is through a strong set of accompanying fiscal institutions. There are three priorities in this regard.

First, the guiding fiscal principles, the long-term fiscal target, and the proposed fiscal consolidation profile should be embedded in clear institutional architecture, together with robust arrangements for fiscal reporting, transparency, and accountability.

As in countries such as Australia this is a principles-based approach that requires the government to outline its fiscal targets and policy approaches, and then to report against these. There is a clear sense of what good practice looks like in this regard, and so these institutions could be established very quickly. The New Zealand legislation could be used for these purposes, for example. There are clear advantages in using a respected, understood approach, and committing to use this structure in the same way that other high performing countries do.

This would also prescribe the nature of comprehensive fiscal reporting – with clear statements of the strategy, priorities, responses to emerging issues, and so on. It would require the government to clearly articulate the path towards improvement and to regularly explain any deviations. This would add to the credibility of the process through establishing a legislative framework. These institutions build credibility by increasing the reputational and political costs of departing from core principles or guidelines (and provide benchmarks against which the government’s performance can be measured).

Second, a credible fiscal improvement process needs to be built on well-respected economic and fiscal forecasts that are produced in an independent way. The data used need to be trusted, and there should be a disciplined process for assessing the fiscal consequences of various policy choices.

Although many countries undertake this function internally (within a Finance Ministry), there is a well-documented tendency towards over-optimism in fiscal forecasts. Particularly for a Scottish Government setting out to deliver a demanding fiscal consolidation, it is important that the economic and fiscal forecasts are understood to be highly credible. The Scottish Parliament recently established the Scottish Fiscal Commission to produce economic and revenue forecasts. With independence an expansion of the functions of the SFC should be considered alongside the establishment on independent National Statistics bodies to produce market sensitive statistics and to enhance Scotland’s statistical capacity. In addition to independence of operations and governance the SFC and any future Statistics body needs to have respected capability.
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B8.80 Third, over time, the establishment of an independent fiscal institution could be considered (along the lines recommended by the Fiscal Commission Working Group in 2013). However, the establishment of an expanded Scottish Fiscal Commission is better seen as a complement rather than as a primary measure. Although these groups can play a useful function in the public debate, as noted above, the evidence is not persuasive that they can provide a strong role in delivering an immediate improvement in the public finances. Clarity and transparency around the target and the trajectory, together with an independent economic and fiscal forecasting capability, as well as scrutiny from Parliament, the public and markets, should provide a sufficiently credible commitment.

Establishing the Institutions

B8.81 Scotland has existing fiscal processes and institutions. But these should be further developed to ensure they are high performing. Building additional fiscal credibility through fiscal institutions would also allow for a more gradual process of fiscal consolidation, which would have clear economic and fiscal benefits.

B8.82 Not all these institutions can be established immediately. Some would take several years to be fully developed. The immediate focus should be on establishing the institutions that provide credibility (fiscal rules, independent reporting, a centralised budget process), and to gradually build the supporting infrastructure (performance based budgeting, spending reviews, fiscal commissions, and so on).

B8.83 Together with developing a robust economic strategy that can strengthen Scotland’s growth profile, building a high-quality set of financial institutions will be critical for Scotland’s sustained economic success.

B8.84 Much of the institutional structure can (and should) be implemented pre-independence within existing rules or early in any transition process. There are several reasons:

- establishing some of these institutions and processes takes time, and it is important to get the design choices made, to build capability, and overcome teething problems/issues prior to independence;
- these institutions can add value in the current state in terms of strengthening the fiscal outcomes; and
- the existence of such institutions will provide a signal of commitment to fiscal credibility in the context of an independence referendum (communicating that Scotland is putting in place high quality fiscal institutions, drawing from international best practice).

B8.85 A fiscal institutions framework that can be put in legislative form (perhaps something like the New Zealand approach) should be developed: fiscal policy guidelines/principles, accountability, reporting and transparency requirements (e.g. that the government tables a fiscal strategy). This could be implemented now.
B8.86 An independent agency that would have responsibility for producing economic and fiscal forecast will be required, building on the Scottish Fiscal Commission. Again, this could start with a more limited role, providing economic and fiscal forecasts to the government based on the current set of powers and expanded on independence.
B9 BUDGET PROCESS

- Robust budgetary decision-making is a necessity for meaningful government control over fiscal aggregates. The international evidence demonstrates that the budget process matters.
- Evidence suggests that the budget process is at least as important as the rules themselves.
- Small advanced economies perform better on OECD measures of high performing budget processes than large economies. There is increasing consensus on best practice across developed countries.
- The Scottish Government should aim to strengthen the decision making process, increase the quality of resource allocation and consider new tools such as a systematic process of structured spending reviews across major spending areas, bottom-up. The best performing countries (such as Denmark) should provide the benchmark.

B9.1 The fiscal institutions described above provide the overall parameters or guidelines for fiscal policy. The annual budget process takes place within these parameters, to allocate resources and to raise revenue in a manner consistent with the fiscal balance targets. Institutions to support the budget process can ensure high quality budgetary decision-making, guaranteeing that the overall resource allocation achieves the best outcomes possible. Budgetary institutions focus on ensuring that the various spending decisions align with the overall fiscal targets, align resource allocation decisions with strategic priorities, and efficiently convert resources into outcomes (‘doing more with less’, driving efficiency and productivity improvements in government agencies).

B9.2 Without a robust budgetary decision-making process, governments will not have an ability to exert meaningful control over fiscal aggregates. The international evidence shows clearly that budget processes have a strongly positive effect on fiscal outcomes. And this research suggests that these budgetary procedures are at least as important for delivering good fiscal outcomes as fiscal rules. It is not possible to achieve a sustained improvement in the fiscal position through non-discriminating spending cuts. Given the nature of the challenge in Scotland, a robust set of budgetary institutions and procedures will be a critical complement to strong fiscal rules.

B9.3 The OECD has a database on budgetary institutions which describe the key elements of a high performing set of budgetary process elements. Small advanced economies tend to perform well on these measures. And significant progress has been made in these areas in many small economies over the past decade or two. There has been a general convergence in budget processes and institutions across developed countries over the past two decades based on increasing consensus as to what good practice looks like. This section will describe the specific experiences in several selected small economies, as well as summarise the international evidence on best practice.
Defining Budget Institutions

B9.4 There are several key components of a high performing set of budgetary institutions:

1) decision-making process: specifically, the role of the Finance Minister relative to spending Ministers

2) clarity around resource allocation: the ability to identify strategic priorities, to allocate resources to key results (performance based budgeting), and with robust accountability and reporting

3) specific tools and instruments to improve the quality of resource allocation, such as spending reviews and benchmarking and scrutiny by Parliament and others including Audit Scotland

Decision-making Process

B9.5 There is well-developed literature on how different systems of budgetary decision-making impact on fiscal outcomes and on the quality of government spending. One of the central insights is that the greater the number of decision-makers, the worse the fiscal outcomes are likely to be. A more decentralised decision-making system will generate worse outcomes in terms of discipline because the individual decision-makers do not face the full costs of the decisions and the accountability is diffused across many parties (the ‘common pool resource’ problem).

B9.6 There is strong empirical evidence to this effect. Many studies have established that fragmented budgetary decision-making caused by a high number of spending ministers leads to higher spending and deficits in OECD countries, as well as in emerging markets. There is also a large body of evidence that shows that centralised budgetary decision-making (e.g., a dominant role for the Minister of Finance) contributes to lower deficits. In addition, more centralised, hierarchical processes – with a strong role for the Finance Minister – also constrains the tendency towards pro-cyclical fiscal policy (in decentralised budgetary systems, it is more challenging to exercise fiscal restraint in good times).

B9.7 The evidence is that a central role for the Minister of Finance in the budget process makes a significant contribution to fiscal performance. A clear allocation of budgetary responsibility to the Minister of Finance contributes to better outcomes in several ways: by ensuring consistency of the decisions taken in the annual budget with the agreed fiscal trajectory (e.g. by administering a multi-annual spending rule that is based on the fiscal target); to fully internalising the costs of incremental spending decisions in a specific agency, by taking a whole of government view on spending; and to being able to make hard trade-offs in a consistent way across spending agencies. This centralised approach also makes it easier to respond quickly to economic and fiscal shocks.
B9.8  Unless aggregate fiscal institutions are supplemented with micro-level institutions, it will be hard to maintain the fiscal consolidation process, with the risk that a bottom-up budgetary process breaches the top-down targets.

**Resource Allocation (Performance-based Budgeting)**

B9.9  The second key element of budgetary process is the nature of the resource allocation process: the basis on which resources are allocated to competing demands across spending agencies. At a high-level, some systems focus on the quantity of resources allocated to various spending agencies (an inputs-based approach) whereas an outputs (or outcomes)-based approach focuses to a much greater extent on contracting for specific outputs or outcomes.

B9.10 The OECD notes that countries report the following benefits from performance-based budgeting: a sharper focus on results within the government; more and better information on government goals and priorities, and on how different programmes contribute to achieve these goals; a greater emphasis on planning that provides key actors with details on what is working and what is not; and improved transparency by providing more and better information to parliaments and to the public.

B9.11 The empirical link between the implementation of performance-based budgeting practices and superior aggregate fiscal outcomes is unclear, but there is a view in several governments that these practices are supportive of fiscal discipline. And it is helpful in securing the productivity improvements within government agencies that are necessary as citizen expectations of government continue to increase despite the existence of fiscal constraints. Overall, a system that allocates resources based on desired outcomes is likely to deliver better fiscal outcomes, as well as better public service outcomes.

B9.12 The supportive nature of a sharper, more granular resource allocation process is likely to be more pronounced in a period of extended fiscal consolidation. These tools will support a more focused process that reduces the risk of blunt spending cuts (e.g. across the board reductions). Organising the budget process around outcomes can be challenging, but the benefits make this a worthwhile investment. Indeed, over the past few decades, there has been a pronounced shift away from budgeting for inputs to outputs and outcomes. This was led by New Zealand and Australia in the late 1980s/early 1990s, and now has been more widely adopted.

B9.13 For example, in countries such as Denmark and New Zealand, there is an agreement with the agency head on the outcomes to be achieved given the resource allocation; and then an annual process for assessment and evaluation. This has led to a more results-oriented culture. However, recent comparative work by the Institute for Government described the weakness of performance management in the UK relative to other countries – suggesting that there may be scope for improvement.
B9.14 There is sizeable technical literature on implementing performance based-budgeting approaches. From this, it is possible to identify several key characteristics that provide the basis for designing a budgeting system organised around outputs or outcomes.

B9.15 First, a clear overall sense of medium-term strategic priorities to provide shape to the direction of the budget: which outcomes matter, how are these areas to be prioritised (including decisions on what the government is not going to do), and a view on the way in which increased resource allocation is likely to contribute to achieving these outcomes. For example, an increasing number of governments are preparing statements of key policy objectives against which progress is regularly reported – and which acts as an organising device for strategic resource allocation.

B9.16 Second, for resource allocation decisions for specific agencies, there should be a standardised requirement for a structured ‘business case’ that describes the way in which the increased spending is expected to lead to improved outcomes. This may include a requirement to identify existing areas of spending that are not effective, and which can be reduced. Agency leadership will commonly have an obligation to use their overall resource allocation to optimise delivery of public goods and services, which implies an on-going process of transferring resources from low to high productivity uses.

B9.17 Third, a process of holding agencies accountable for outcomes after the event. If spending agencies cannot demonstrate the way in which the increased resources have led to improved outcomes, it will be more difficult for them to bid for new funds in the future. An important key role for central agencies (particularly the Ministry of Finance) is to monitor and evaluate whether resources are being used effectively.

B9.18 This is not a hard science and causality is often difficult to identify. But a structured process of analysis can provide useful discipline on the resource allocation process. This would require investment in preparing more detailed financial and management information, including performance tracking.

**Specific Budgeting Tools**

B9.19 The annual budgetary process tends to focus on marginal spending requests rather than the full government spend. But to get improvements in productivity across the full government budget, new approaches are being used to improve the efficiency and quality of overall government spending. These are particularly useful both for a programme aimed at improving the fiscal position, as well as on an on-going basis.

B9.20 One good example is spending reviews which look at the overall spending within an agency or sector. During the crisis period, many governments undertook spending reviews (focused on key spending areas) to identify efficiency savings.

B9.21 The OECD categorises spending reviews as either functional in nature, focused primarily on improving the efficiency of existing programmes; or strategic reviews, which extend to prioritisation and look at what the government should and should not be doing. These
spending reviews are commonly led by the Finance Ministry, with the involvement of line agencies. There is now a well-developed view on how to structure these spending review processes effectively; they can be effective as devices to raise productivity in government.

B9.22 Spending reviews can also be integrated into the process of government budgeting. For example, the Finance Ministry in Denmark has a rolling programme of spending reviews, each taking 2-6 months, depending on the size and complexity of the scope. In a typical year, 2-3 reviews, each covering major parts of government spend, as well as 5-10 smaller reviews, are completed. The reviews follow a standard methodology of establishing cost baseline, estimating budget improvement potential based on benchmarks and bottom-up analysis, and developing specific actions to be taken to capture the identified potential.

B9.23 Governments are also using benchmarking approaches across government agencies to identify efficiency opportunities in key areas (particularly in support services, to free up resources for citizen facing services). In 2010, for example, central agencies in New Zealand launched BASS (benchmarking of administrative and support services) where agencies provided data on a range of functions on standardised dimensions (cost of office space, person per square foot, HR support ratios, and so on). This enabled best practice to be identified across the public sector, and for targets to be set for participating agencies. This process identified significant efficiency savings for under-performing agencies if they moved to the median or the frontier (of around 15-20%).

Implications for Scotland

B9.24 Scotland needs to achieve sustainable finances. Strengthened budgetary processes will be required to ensure that decisions with respect to resource allocation are made as effectively as possible.

B9.25 This discussion considers priorities for Scotland in terms of the three dimensions of budgetary process described above.

(i) Strengthen the Decision-making Process

B9.26 A priority is to have a well-functioning, centralised decision-making process that is led by the Minister of Finance. This must be supported by strong accompanying capability in the Ministry of Finance. There should be a tightly structured annual budgetary process, which allows time for both high quality decision-making as well as external scrutiny (including by Parliament).

B9.27 The agreed programme to achieve a sustainable fiscal position will generate a series of annual fiscal aggregate targets, which will vary over time, as economic and fiscal outcomes develop. This will provide a binding spending cap that will govern the annual budget process, in both the current year and for subsequent years. This will provide the frame for the budgetary process to be led by the Finance Minister.
B9.28 The priority task for the Minister of Finance is to conduct negotiations with the spending agencies. This should be informed by a clear statement of the government’s strategic priorities, as well as by high-quality spending proposals from agencies, and a rigorous process of review of these proposals by central agencies.

B9.29 These budgetary processes should be implemented immediately. Scotland can take aspects of these processes from existing high-performing systems and adapt as appropriate to fit into the specific Scottish context.

(ii) Increased Focus on the Quality of Resource Allocation

B9.30 To an increasing extent, Scotland needs to adopt a more performance or outcome approach to budgeting. The focus should be achieving stronger results through spending, rather than having the quantum of spending as a measure of commitment. The fiscal challenges will create a need for a rigorous approach to prioritisation of government spending. Structures should be established to allow for prioritisation both at macro-level and at spending agency level. At the agency level, budget bids from agencies need to have a clear business case in terms of how the additional resource allocation will contribute to superior outcomes. This may include some ability to identify low value programmes that can be discontinued. This will likely involve some investment in building information systems and capability to undertake this process in a disciplined way. This can be developed over time.

B9.31 Systems will also need to be developed to allow for a stronger approach to the assessment and evaluation of various programmes: what is working, what is not, and how improvements can be made. This will take time, but it is central to ensuring that good outcomes can be generated.

(iii) Introduce New Tools

B9.32 As with countries such as Denmark, Scotland should consider implementing a systematic process of structured spending reviews across major spending items (to ensure that they remain aligned with government priorities, and that the spending programmes are efficient). Scotland has conducted spending reviews previously, but these do not seem to have been as granular (or bottom-up) as the systematic spending reviews that have occurred in other jurisdictions. There is much insight that can be taken directly from organisations such as the OECD, and from other governments, on the best way in which to structure these reviews.

Implementation

B9.33 Strengthening the annual budgetary process should also be done now – making any required adjustments to the current process (particularly, the role of the Minister of Finance in terms of decisions on the fiscal envelope, specific allocation of resources). This is a good thing to do pre-independence, to ensure high quality spending decisions.
B9.34 A structured spending review process of major spending categories (specify an approach and timeline to review major spending categories, agencies over the next several years) should be implemented. This is a ‘no regrets’ move, and would generate benefits under current arrangements. The scope of this process should be agreed, and accountabilities assigned.
B10 TAXATION SYSTEM: PRINCIPLES & STRATEGY

- Borrowing on the work of the Scottish Government’s Fiscal Commission Working Group we highlight the issues and opportunities for the taxation system in Scotland and recommend further work.

- The decisions that are taken by government on the design of taxes and tax rates set should take account of the likely economic impact on the economy, including on behaviour of individuals and on businesses. This should include regard for maximising revenues, since increasing (or reducing) rates does not always lead to increased (or reduced) revenues; taxpayers can often change behaviour as a result of the changes made.

- A comprehensive review of the Scottish taxation system beyond income tax is recommended drawing on the best global expertise and experience with a review to recommending reforms to improve simplicity, neutrality and flexibility.

- A cross-partisan approach is sought.

B10.1 In this section we consider, only briefly, the strategy behind the taxation system and the principles that underpin it. It is not a core requirement of this Commission’s work but some principles should, we recommend, assist the direction of further work and policy decisions from the Scottish Government.

B10.2 In 2013 the Fiscal Commission Working Group published “Principles for a Modern and Efficient Tax System in an Independent Scotland”. That work stands largely as is, although further thought is needed to encompass subsequent changes to taxation and welfare policy and also to the broader economic context given the Brexit process and what we come on to recommend in subsequent work on Monetary Policy. The report considered the work of the Mirrlees Review of the UK tax system undertaken by the Institute for Fiscal Studies in 2010-11, the most comprehensive review of the UK system to date.

B10.3 The 2013 Fiscal Commission Working Group report said: “In looking at reviews such as the Mirrlees Review and the experiences of other countries, it is important not to pick individual elements to argue in favour or against the merits or demerits of a particular action. Such an approach would be partial, misleading and flawed. Any framework which looks across the entire system, by definition, needs to examine the totality of the proposition and the overall political, economic and social objectives trying to be achieved”.

B10.4 This is a sound and balanced perspective and applies across the course of the entire Sustainable Growth Commission’s systemic approach. Debates on welfare and taxation in Scotland have, in recent years, focussed on the margins of the overall strategy and without a reference to the principles underpinning the system. This has tended to be focussed on whether policy should implement what has been done at a UK level, or indeed mitigate it. Such a piecemeal approach referencing singular policy moves at only the UK level only would produce very sub-optimal policy for Scotland.
B10.5 We recommend that when considering taxation strategy and principles that the Scottish Government, and indeed all policy makers, give full consideration to the conclusions of the 2013 report. We also recommend further that:

1. That for the transition period, stability, certainty and predictability will be especially important and policy must be set as part of the overall sustainable economic growth strategy.

2. Due consideration must be given at all times to the impact of any moves on behaviour and incentives and therefore on revenues and the health of the tax base. Increasing (or reducing) rates does not always lead to increased (or reduced) revenues, since taxpayers can change behaviour as a result of changes made.

3. Actively increasing the size and health of the tax base and optimising revenues should be a priority. Lessons should be learned and acted upon purposefully. One of the core advantages of small advanced economies is the ability to act quickly and purposefully.

4. A comprehensive review of the Scottish taxation system should be established which draws on the best global expertise and experience. This review should report to Parliament the opportunities for reforms to the system that will improve its simplicity, neutrality, stability and flexibility – the principles noted below. A cross-partisan approach should be sought to setting the longer-term framework and strategy that will therefore stand the test of time.
Key Conclusion from Fiscal Commission Working Group 2013 Report

Independence would provide a unique opportunity to develop a modern and efficient tax system. If Scotland was to get it right, it could be used as a powerful tool to grow key areas of the economy and tackle longstanding weaknesses. An efficient system could be a major international competitive advantage for Scotland supporting more investment, jobs and growth.

Establishing such a system will be challenging and should be phased over time. However, the benefits of moving to such a system will undoubtedly pay off in the long-run.

Past decades have seen an increasing level of complexity of the UK tax system. The administration costs associated with tax collection in the UK are higher than in many competing countries. According to the OECD, administrative costs in the UK amounted to 0.73% of all tax revenues in 2013, compared to 0.29% in Switzerland, 0.39% in Sweden, 0.41% in Norway and 0.47% in the United States\(^\text{33}\). Additionally, the UK has a significant ‘tax gap’ with the latest official data from HMRC estimating this to be £36 billion in 2014-15, which is 6.5% of theoretical tax liabilities\(^\text{34}\). The ‘tax gap’ is the difference between the quantity of tax that should, in theory, be collected by HMRC, against what is actually collected.

Independence would grant Scotland full control of all tax revenue and expenditure levers with autonomy over tax design, collection and implementation. It would offer a unique opportunity to design a modern and effective taxation system that was not burdened by historical legacy and years of adjustments, which result in complexity, cost and confusion. Scotland would be able to re-examine the entire tax framework and to design a system based upon specific Scottish circumstances, preferences and principles, while incorporating modern technology to minimise administration costs.

Scotland would have the opportunity to design a new tax system built around Scottish circumstances and preferences. Scotland would need to build skills and capacity over a transition period, supported by, in all likelihood, the use of short-term shared service agreements for instance. It would have the opportunity to communicate clearly and early the direction of travel it intended to move – and the principles it would base the system on.

The Scottish Government would be able to build upon the capacity and lessons learnt from the implementation of the tax powers in the Scotland Act 2012 and Scotland Act 2016 and the establishment of Revenue Scotland to assist with the transition and implementation of new powers.

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\(^{33}\) Tax Administration 2015: Comparative Information on OECD and other advanced and emerging economies (OECD 2015) Table 5.4, Page 181

Principles of a Taxation System

B10.6 The principles for an effective taxation system are well established and were set out by Adam Smith in the Wealth of Nations, first published in 1776. He proposed four maxims that a fair tax system should abide by:

- **Equity**: “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”

- **Certainty**: “The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.”

- **Convenience**: “Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributors to pay it.”

- **Efficiency**: “Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.”

B10.7 The report on by the Fiscal Commission Working Group set out principles for a modern and efficient tax system in an independent Scotland, which remain valid:

1. **Simplicity**: “A simple tax system is one in which tax rules and obligations are well known, easily understood, and where liability is clear. With a simple tax system, taxpayers can anticipate in advance and factor into their decision making, with minimal burden and uncertainty, the tax consequences of an action. Simple tax systems improve transparency – and in turn political and administrative accountability. Easily understood systems minimise the burden to both taxpayers and the exchequer of administration and compliance. A simple system is also fairer, in that it boosts accessibility. It also improves the integrity if the system by minimising the requirement for time and money to be spent on tax specialists to calculate or avoid tax burden.”

2. **Neutrality**: “It is important to ensure that decisions regarding a taxation system are made on merit, rather than on the basis of tax consequences. Neutrality is important in minimising negative or unintended effects of taxation – such as on labour supply decisions and the allocation of resources. It does not however, necessarily imply that the tax system should not be utilised to influence behaviours, especially where welfare and efficiency can be improved via taxes.”

3. **Stability**: “The stability and predictability of the tax system relates both to the stability of revenues, which governments raise through taxation, and the stability of tax rules, which face individuals and businesses. A key aim of any tax system should be to ensure that the revenue stream from taxation should be relatively predictable at least to the extent that it meets a minimum level, in order to facilitate forward planning. Stability of
tax rules and procedures allows for predictability and certainty in the decision making and planning of individuals and businesses.”

4. Flexibility: “In light of evolving economic, social, and technological conditions, it is generally accepted that a tax system should be sufficiently flexible to be responsive to change – particularly in a dynamic and constantly evolving global economy. One particular area of focus is the tax principles and frameworks for the digital age. A well-designed tax system strikes an appropriate balance between flexibility and stability, enabling a government to respond to changes while still creating a system which allows predictability and certainty.”

B10.8 These principles have been adopted by the Scottish Government and applied to the limited tax powers the government currently has. We recommend that these principles should underpin the transfer of taxation powers and the setting of future tax policy.
B11 MANAGING THE GOVERNMENT’S BALANCE SHEET

• Substantial value to governance and finances will flow from effective management of the public sector’s portfolio of assets and liabilities; and its balance sheet. This does not mean the privatisation programmes such as those that the UK has pursued, but maximising value to the public purse of assets it holds.
• The IMF estimates developed world balance sheets are commonly c70% of GDP. The UK balance sheet is smaller and for many countries the assets outweigh the stock of public debt.
• Better allocation of capital should be a priority at all times. A good understanding of the balance sheet gives the most informative measure of financial sustainability.
• Examples are examined from small advanced economies to better allocate capital and assets and manage debt and risk.
• Scotland should quickly establish a best in class Debt Management and Assets Office, with consideration being given to allocating broad aggregate balance sheet responsibilities to this institution.
• A comprehensive and accurate inventory and valuation of assets and liabilities held by the Scottish Government and public sector should be undertaken and maintained.
• Opportunities for capital release into the Fund for Future Generations should be reviewed every 3 years.
• An on-going and robust system for asset management and reporting should be created.

B11.1 Much of the attention in government financial management relates to the nature of the aggregate fiscal path as well as the ability to exert fiscal control through a high quality budgetary process. But an additional area of substantial value to the government comes from the efficient, effective management of its portfolio of assets and liabilities (the ‘government balance sheet’). On the asset side this includes financial and commercial assets, as well as physical assets such as buildings, infrastructure, and defence and national heritage assets.

B11.2 Across the developed world, the IMF estimates that the size of central government balance sheets is commonly above 70% of GDP (Figure 7-5). For example, the UK has non-financial asset holdings of around 50% of GDP, slightly below the advanced economy average, and financial asset holdings of an additional 30% of GDP. The New Zealand government reports total asset holdings of about 100% of GDP. For many countries, these holdings of assets outweigh the public debt stock.

B11.3 Better allocations of capital across priority areas can free up capital for new needs (including fiscal consolidation), and more efficient management of these assets and liabilities can make a substantial contribution to the fiscal position. A good understanding of the government
The balance sheet also gives a superior measure of fiscal sustainability than simply referring to the fiscal balance or the debt level.

B11.4 Small countries, from New Zealand to Norway, have a record of institutional innovation in government assets and liability management. For example, New Zealand led the world in establishing a full government balance sheet in the early 1990s. And the IMF notes ongoing progress in the preparation of comprehensive balance sheets across many advanced economies. There is much that Scotland can learn from the international experience in establishing world-leading public sector financial institutions.

B11.5 A traditional argument for preparing government balance sheets is to strengthen fiscal transparency. For example, a clear statement of government assets and liabilities reduces the risk of fiscal consolidation through accounting trickery – selling assets, avoiding recognising liabilities or investing using public private partnerships rather than government debt, and so on. These accounting devices can generate a meaningful fiscal impact. But increasingly the focus is on the extent to which stronger government balance sheet management can lead to improved fiscal decision-making and stronger fiscal outcomes.

**Approaches to Government Balance Sheet Management**

B11.6 The way in which these assets and liabilities are managed, and in which capital is allocated, makes a direct contribution to the quality of fiscal outcomes. Drawing from the international experience, particularly from small economies, this discussion considers two themes in government balance sheet management.

**Effective Management of Government Assets**

B11.7 The materiality of the government’s asset portfolio means that improvements in the way in which these assets are managed are likely to have a significant impact on fiscal outcomes. For example, a 1% across-the-board productivity improvement in the government asset portfolio (of say 70% of GDP) would result in a fiscal saving of 0.7% of GDP. Of course, not all assets are subject to these types of productivity improvements, but the point is that small improvements on a large asset base can generate substantial fiscal benefits.

B11.8 Consideration of the international experience with respect to asset management suggests several classes of improvement that are relevant to Scotland.

B11.9 First, clearly allocating ownership to specific agencies can make a difference: as managers take greater responsibility for managing assets and allocating capital. This is less likely when asset ownership and decision-making rights are less clear. This was an immediate benefit in New Zealand when agency balance sheets were required to be prepared, with ownership rights vested in the agency. Agencies took their asset ownership role much more seriously.

B11.10 Second, financial incentives should be created to manage assets efficiently. A classic example of this is a capital charge, in which the Ministry of Finance charge the asset-owning agency an amount that reflects the cost of capital on the asset. The intuition is that the
agency should face the full cost of continuing to hold that asset (rather than seeing the cost of capital as free) to prompt consideration of whether asset ownership is required to deliver the outputs and outcomes they are meant to deliver.

B11.11 Many countries have some form of capital charge, such as New Zealand, Australia and the UK. There is an on-going debate about the effectiveness of these provisions, but some charging mechanism seems appropriate for consideration. Another way of approaching this issue, seen in countries such as Finland, is to charge rent to government agencies that are using government property. This creates a similar financial incentive system as the capital charge, but without the complexity.

B11.12 Third, encouraging efficiency through benchmarking exercises. For example, the UK’s National Audit Office reports a recent benchmarking exercise through the High Performing Property Initiative. In this exercise, each property-owning agency reports on property costs and occupancy, which are then benchmarked against public and private sector peers. They report significant savings, from reducing office space required and increasing property utilisation (annual savings of over £1 billion).

B11.13 Similarly, New Zealand has recently benchmarked the use of real estate and office space across government agencies. This data was used to create baselines that provide formal guidance for agencies in terms of appropriate use of office space, and has reduced the amount of office space that is required. In many cases, surplus accommodation has been sold or re-purposed for other uses.

B11.14 Once comparative data has been obtained from the benchmarking exercise, work can be done to better understand the sources of the variation and to identify ways in which improvements can be made, with focus on locations where capital productivity is low.

B11.15 Fourth, is the need to build capability around asset management. Many advanced economies had developed decentralised public sector management systems, in which individual agencies were responsible for operations (including asset management). However, specific agencies may not have access to the capability to manage their assets well in instances where these require specialist skills. Over the past several years, there has been a tendency towards establishing more centralised asset management functions, particularly with respect to property management. Examples can be found in Australia, the UK, and New Zealand.

Debt and Risk Management

B11.16 In addition to managing the government’s asset portfolio, it is also important to actively manage the government’s debt portfolio, as well as the many types of risks (and contingent liabilities) that sit on the government balance sheet.

B11.17 Public debt management offices are a very well-developed institution and there is a keen sense of what good practice looks like in this regard. These offices raise and manage the government’s debt portfolio, aiming to minimise the government’s borrowing costs. In
some cases, these offices also have a mandate to contribute to the liquidity and maturity of
debt markets in a country. These functions generally sit within the Finance Ministry, but
operate independently (subject to risk and other guidelines). There are also examples of
these debt management institutions being responsible for managing some types of assets
(generally financial assets). They would also manage local government debt.

B11.18 In addition to the efficient management of these liabilities, the government needs to
manage the significant fiscal risks that sit on government balance sheets. Some of these
risks are straightforward financial risks (valuation risks, and so on). But there are frequently
many other risks and contingent liabilities that need to be actively managed. A recent
National Audit Office report on the UK Government’s asset and liability portfolio
documented the many risks and contingent liabilities that the UK was exposed to through
its increasingly diverse asset holdings.

B11.19 A balance sheet perspective makes it more likely that there will be a structured approach
to the management of these risks. In countries like New Zealand, the Treasury (including
the Debt Management Office) has responsibility for this. But various other organisational
forms, including dedicated asset owning agencies, are also observed (for example, UK
Government Investments). An appropriate set of organisations and accountabilities should
also be established in Scotland as the nature of its asset holdings becomes clearer.

Implications for Scotland

B11.20 The initial priority for Scotland is to quickly establish a ‘best-in-class’ debt management
office to manage the debt stock, and to lead on raising further debt to fund the deficit. The
ability to raise debt efficiently and quickly, and to manage this debt on the best possible
terms, will make a significant contribution to manage Scotland’s fiscal outcomes. There are
many examples of high quality debt management institutions in small advanced
economies, and Scotland should replicate these functions and shadow seconded staff from
successful outside DMOs in the early phases. This is also a way of building on the financial
sector strengths that Scotland already has.

B11.21 There is a good argument for this institution to have broader aggregate balance sheet
responsibilities, particularly for the financial asset holdings. In that role, it would need to
work in close cooperation with the asset management side of the Fund for Future
Generations. It could also lead on any asset sales processes, project financing (an
investment bank for the Scottish Government), as well as the management of financial
assets as well as some contingent liabilities. This would be explicitly an Asset & Liability
Management Office (as is the case now in New Zealand), or it could be a Debt Management
Office, but with broader responsibilities.

B11.22 This agency would likely sit within the Ministry of Finance but would have a high degree of
autonomy, independence, and its own credibility (similar to the UK DMO). Over time, this
agency would become accountable for significant amounts of capital.
B11.23 The second priority is to develop a comprehensive inventory of assets and liabilities that the Scottish Government would hold. Scotland already has existing asset holdings, and there would be a further transfer of assets and liabilities from the UK to an independent Scotland as part of the negotiation. There should also be an agreed process for asset and liability valuation, and assigning specific ownership, accountability and decision-making rights with respect to those assets, so that agencies know what they are responsible for. This would be an on-going process, but it is an important element to get right early.

B11.24 Third, an initial review of the extent to which the assets on the government balance sheet should remain so should be undertaken: is there a clear public policy objective associated with on-going government ownership so that assets are stewarded effectively? Or can the capital can be recycled into higher value uses or released for debt reduction? This should be done in a structured way, to ensure high quality decisions are made for the long-term. But this may have the potential to make a meaningful contribution to the fiscal consolidation process at the same time. This would not drive government policy on the delivery of public services and would be an on-going process, with an initial review undertaken in the first 2-3 years.

B11.25 The final step, which will take some time to implement, is to establish a robust system for asset management and reporting. For example, creating financial incentives to impose on asset owners, building appropriate asset management capability, undertaking benchmarking exercises, and so on. There should be regular reporting and monitoring of this portfolio of assets and liabilities at both agency and whole-of-government levels.

Implementation

B11.26 The basic infrastructure around balance sheet management can be established. Agreement should be reached on the accounting standards that are to be used (e.g. guidance from New Zealand, the UK), as well as on how comprehensive these should be in the first instance. The inventory and valuation process should be commenced and ownership rights formalised Consideration should also be given to establishing a central asset management function for some assets (e.g. financial assets). A process for balance sheet reporting should also be developed.

B11.27 A review of government asset holdings to identify whether there are any material opportunities for capital release or for reallocation should be undertaken. But, for the most part, balance sheet management is an on-going task.
B12 DELIVERING A CREDIBLE & SUSTAINABLE FISCAL FRAMEWORK & POLICY

- Target a deficit value of below 3 per cent within 5 to 10 years.
- National debt should not increase beyond 50% of GDP and should stabilise at that level.
- Borrow only for public investment in net terms over the course of the cycle.
- During the transition period real increases in public spending should be limited to sufficiently less than GDP growth over the business cycle to reduce the deficit to below 3% within 5 to 10 years. At trend growth and target inflation rates this would mean average annual cash spending increases of above inflation in contrast to the Scottish budget experience under the UK regime of recent years and that scheduled for the remainder of the current planning period.
- The impact of fiscal management on growth must be tended to and it should be noted that this rule will apply over the business cycle. This means that in periods where growth is expected to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth.
- Governance recommendations from preceding chapters should be delivered swiftly and purposefully.
- Initial premiums on borrowing costs compared to the UK are not anticipated to be problematic but the target of policy should be to reduce the gap towards small advanced economy benchmarks. An assumption is made that initial debt interest costs could be 100bps above UK levels, the level estimated by the ratings agencies in 2014.
- 10 year debt accumulation is not anticipated to rise over 40% of GDP. Scotland’s commitment through the Annual Solidarity Payment on UK debt servicing would affect deficit rather than debt.
- The analysis set out in this report shows that the target of a deficit value of below 3 per cent within 5 to 10 years can be achieved without any assumptions in increased growth. Achieving the growth aspirations set out in Part A would have the effect of bringing forward the timescales required to meet the fiscal target.
- A potential transitionary fiscal boost to growth should be considered and should be consulted on and considered depending on the prevailing economic circumstances and the perspectives and price required by debt providers.
Fiscal Rules

B12.1 In chapters B7 to B11 of the report we detail the analysis we have drawn upon from the record and performance of small advanced economies that have delivered successful and credible governance frameworks and policies.

B12.2 From this work, we conclude that the immediate fiscal policy priorities for Scotland will be to agree a binding framework to ensure:

- The deficit is reduced to below 3 per cent of GDP within 5 to 10 years;
- That national debt does not increase beyond 50% of GDP and stabilises. This will automatically constrain what fiscal deficits are allowed;
- Borrow for public investment only over the course of the cycle.

B12.3 In the early years, there will be a need to establish and maintain fiscal credibility whilst ensuring that the fiscal policy implemented supports rather than undermines the underlying growth performance of the economy.

B12.4 The UK’s debt will remain the responsibility of the UK Government after Scotland becomes independent, as recognised by HM Treasury in its 2014 announcement. By definition, this means that an independent Scotland will start with zero debt. However, it is likely that an independent Scotland will agree to contribute to the debt servicing costs of a fair and reasonable share of UK debt (net of a share of assets). As set out in chapter 6, using 2021-22 as an illustrative starting point for an independent Scotland would be a deficit of 5.9% of GDP (excluding oil revenues), of which 1.6% of GDP will be the result of debt servicing payments to the UK Government (and this element will reduce over time, with inflation and growth, reducing the overall deficit).

B12.5 The commitment to servicing this debt means that Scotland’s deficit will be higher than it otherwise would have been. Funding this deficit may require borrowing and lead to a build-up of Scottish debt.

B12.6 To achieve a public debt to GDP ratio of 50% or less within ten years, it will necessary for the average deficit to be below 5% and on a downward trajectory.

Governance

B12.7 The key priorities for governance include:

- Developing a fiscal institutions framework in legislative form: the fiscal policy guidelines/principles, the accountability, reporting and transparency requirements (e.g. that the government tables a fiscal strategy). The specific targets, the timelines, and so on, could follow once there is greater clarity on the starting point in terms of the fiscal deficit and public debt stock.
• Establishing an independent agency that would have responsibility for producing economic and fiscal forecasts, building on the Scottish Fiscal Commission’s remit.

• Strengthening the annual budgetary process (in particular, strengthen the role of the Minister of Finance in terms of decisions on the fiscal envelope, specific allocation of resources).

• Implementing a structured spending review process of major spending categories (specify an approach and timeline to review major spending categories, agencies over the next several years). This is a ‘no regrets’ move and would generate benefits under the current arrangements.

• Establishing a DMO/ALMO with overall responsibility for managing the portfolio of government assets and liabilities.

• Commencing a review of government asset holdings to identify whether there are any material opportunities for capital release or for reallocation (e.g. of vacant buildings).

Delivering the Fiscal Targets

B12.8 The required journey to a fiscally sustainable position would be a necessary challenge for a newly independent Scotland, but the scale of what is required is well within what several other successful small advanced economies have achieved.

B12.9 The core lesson from other small advanced economies is that the most effective way to reduce the legacy deficit would be to control spending growth to no more than economic growth. It is important to strike a balance between fiscal credibility and reform with tending to the role of government spending in supporting growth, especially across a cycle and in support of longer term sustainable growth strategy.

Borrowing Costs

B12.10 The contribution made by Scotland to historic debt servicing costs, as part of the Annual Solidarity Payment, will be based on the existing interest rates on UK debt and so will be unaffected by the costs of UK or Scottish borrowing.

B12.11 However, during the deficit reduction period, an independent Scotland would require to borrow to fund the reducing deficit and so the borrowing costs that a newly independent Scotland would face become relevant. The 10-year bond yield for the UK is currently at 1.65% (Figure 12-1). In general, small economies have stronger credit ratings and low yields.
Perhaps the best way is to look at the interest rate time series when small countries come under fiscal stress (NZ, Finland, etc.): it rose ~1%, before declining as things got under control. As a first approximation, the additional premium with independence as the country establishes credibility and a credit record could mean an extra ~100bp on rates relative to the UK – which would take Scotland to about 2.3%. Over time, this uncertainty would dissipate – and rates would reduce further. Other factors that make a difference include the liquidity of the bond market, the extent of portfolio inflows (whether institutional investors bring money into Scotland), as well as the risks associated with private debt. For the purposes of the analysis of the fiscal strategy set out below, the conservative assumption has been made of initial debt interest costs at 100 basis points above the current UK bond yield (based on the conclusions of the ratings agencies in 2014).

Set-up Costs and Invest to Save

During the transition period, the government will require to invest in best-in-class new institutions for public administration and delivery of services, as it transitions from the Whitehall led delivery at present.

This investment would cost resource up front but deliver exchequer savings in the longer term because administering from Scotland should be more efficient and lower cost than from London. Moreover, the money spent, in both capital and in salaries would see a greater proportion circulated in the Scottish economy and therefore flowing back in future revenues. There may be advantages of scale in UK government administration, but these are not obvious.
B12.15 We commissioned Professor Dunleavy of the London School of Economics to undertake an independent assessment of transition costs and assessed the period in which this will become exchequer positive. This research estimated the transition costs at £450 million over 5 years, and so an average of £90 million per year (0.05% of GDP). These costs would be recouped well within the first decade from the tax revenue associated with employees alone as well as providing further economic multiplier effects. Moreover, the intention to create best in class institutions will provide opportunities for savings in the longer term, in particular from efficiencies in the costs of governance.

Scotland’s Fiscal Strategy

B12.16 For the initial consolidation period, we recommend modest real terms increases in public sector expenditure.

B12.17 The impact of fiscal management on growth must be addressed and it should be noted that this rule will apply over the business cycle. In periods where growth is expected (by a new independent institution tasked with providing forecasts) to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth back to or above the trend rate.

B12.18 At Scotland’s long-term trend GDP growth rate of 1.5%, and inflation at 2%, this would mean that nominal increases in public spending of 2.5% would reduce the inherited deficit from 5.9% of GDP to less than 3.0% of GDP by year 9 (Figure 12-2). Over a ten-year period that would require borrowing that would build up to 36% of GDP, well within the 50% limit of the proposed fiscal framework.

B12.19 This analysis takes account of borrowing costs (assuming a risk premium of 100 bps) and savings of 0.3% GDP\(^{35}\) associated with investment in best-in-class institutions realised over a three year period from year 5.

\(^{35}\) This saving of 0.3% is a conservative target for savings from best in class institutions. Improvement to the tax system alone, matching the best performing small economies in terms of the costs of collection as set out in Chapter 12, would realise more than half of these targeted savings. If greater savings can be achieved, this would decrease the time taken to reduce the deficit.
Figure 12-2 – Growth & Deficit Reduction (Real Public Spending Change 1% less than Growth)

Public Sector Balance as % GDP
(Spending Change 1.0% less than Growth rate)

Source: Sustainable Growth Commission Analysis

B12.20 This rule would also have the same effect of reducing the deficit to less than 3% of GDP, at different levels of growth. So, if the trend growth rate of the Scottish economy was to increase, in line with the small advanced economy comparators, this would give the Scottish Government options to accelerate the reduction of the deficit, increase public spending, reduced taxation, or some combination of these.

B12.21 Other options such as reducing spending in some areas (for example, in defence), setting more ambitious targets for savings from investing in best-in-class institutions and increasing the tax base through population growth would also give the Scottish Government options to accelerate the reduction of the deficit.

Potential Fiscal Boost in Immediate Transition Period

B12.22 Establishing credibility within the first few years by following this fiscal strategy will be important. However, the analysis shows that the deficit can be reduced to sustainable levels within 5-10 years, whilst maintaining debt levels well within the 50% limit set out in the proposed fiscal rules.

B12.23 This could mean some scope for additional borrowing to fund investment for growth. Whether this would be the most appropriate economic and fiscal policy will depend on the economic environment at the time, which will be determined by a range of factors such as the time it takes the UK and Scottish economies to adjust to the shock of Brexit and the management of the economy by the UK Government over the next few years.
B12.24 There will be a trade-off. On the one hand, borrowing to invest in measures to boost growth could be interpreted by markets as a lack of commitment to fiscal consolidation and so undermine efforts to establish fiscal credibility despite extra revenues generated by that investment. On the other hand, a pause may provide some space and confidence to buffer this economic shock. Fiscal consolidation may be self-defeating if commenced too aggressively.

B12.25 Moreover, a comprehensive strategy to boost economic performance will also be a factor in establishing credibility and a fiscal boost focused on increasing the productive capacity and productivity of the economy could help to establish fiscal credibility, provided the strategy was clearly set out.

B12.26 To understand the nature of the trade-off, and the options available, it would be useful to commit to consulting with markets and business to understand the key costs and benefits with the initial phasing of the fiscal consolidation process. This consultation should take place during the negotiation period, after a referendum but before fiscal powers are transferred to the Scottish Government.

B12.27 It is also important that any initial 'fiscal boost' be designed for maximum economic benefit, and with the long-term in mind. It should be targeted at the key risks – such as lower business investment – and should be designed in a way that the measures can easily be reversed. This could include infrastructure investment and targeted tax relief (e.g. on business investment). To the maximum extent possible, it should also be consistent with the long-term economic strategy, rather than simply a short-term consumption boost.
B13 Conclusion

B13.1 This section of the report has demonstrated the fundability, viability and desirability of improving the fiscal framework, policy and approach to Scotland’s public finances.

B13.2 By looking to the best examples from around the world we demonstrate the method by which Scotland can dramatically improve governance and outcomes and maintain debt at much lower levels than the UK has proven able to. We have also set out what we hope is a model of respect for the rest of UK and its interests and position. In particular we hope that the idea of an Annual Solidarity Payment will demonstrate the spirit of intent for both meeting shared obligations and ongoing collaboration.

B13.3 Wherever possible we have drawn on the latest official data for our presentation and from independent analyses that should make the core of the report beyond reasonable question. It is of course the case that the official numbers will change over time. That should not dramatically alter anything in this report other than the timing of when targets are reached.

B13.4 What we hope is now clear is that it is not a matter of whether Scotland can afford to manage its own finances but whether it should. It seems to us self-evident that continuing on the current UK model is unlikely to produce better outcomes than those seen at present.

B13.5 The counter factual is not clear from the current policy debate. How the UK proposes to achieve its fiscal targets and the implications for the UK regions and nations is, as yet, a moveable feast with each budget and statement. What is clear is a material, real terms reduction in the funding of the Scottish Government.

B13.6 We are of the core view that the performance of the economy needs carefully stewarded alongside the public finances. It is possible for Scotland to put its finances on a globally recognised credibly sustainable footing within five to ten years while maintaining inflation plus increases in public service funding as long as they lag trend growth. The greater the lag the faster the fix and we have set out options above for policymakers to consider. The target should be to achieve deficit targets within five to ten years.

B13.7 There is a lot in this report that should serve all sides in the political and policy debate. While we recognise that many do not yet support the case for independence we also hope that we have been able to demonstrate that it is, financially, a perfectly viable option. Indeed we go further and suggest that following the approach outlined in this report is an absolute imperative if improved economic performance is to become a reality.

B13.8 More than anything it is clear that the entrenched nature of the political debate in Scotland has seen too many capable minds closed to real possibilities. While we do not expect to persuade everyone, we do hope that we can engage in a manner that elevates the current debate.
B14 PART B: SUMMARY OF MAIN RECOMMENDATIONS

B14.1 As with Part A we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached and co-operation sought for policies that would benefit Scotland’s performance long-term.

31. Annual Solidarity Payment: Following a successful independence vote an Annual Solidarity Payment should be created to allow the Scottish Government to pay an agreed share of the servicing of a net balance of UK debt and assets and any continued shared services payments.

32. Comprehensive Review of Inherited UK Spending Programmes: reporting within two years this would analyse the inherited strategy and choices for spending across the UK programmes excluding defence which would be subject to separate consideration. The purpose would be to identify savings from costs that need not be replicated, and tailoring to Scotland’s specific position and needs. A saving of £1 billion should be targeted. As government functions are transitioned, further savings should be targeted by replacing the UK approach with institutions modelled on the best of the small advanced economies e.g. in tax collection. This element should target a saving of 0.3% of GDP by year 5.

33. Standing Council on Scottish Public Sector Financial Performance: this should be established to institutionalise the high performance and best practice (compared internationally) across the public sector; incentivising, celebrating and rewarding the best outcomes and efficiencies.

34. Fund for Future Generations: this fund should be created from all windfall revenues including any from north sea oil and gas. The focus of the fund would be on risk bearing by the public sector in exploiting inter-generational opportunities in the areas of Inclusive Growth, Innovation and Science, Infrastructure and the Green Economy. Further work is required on the detail of its remit and governance.

35. Fiscal Targets: should be established and adhered to:

   i) Public debt should be maintained at no more than 50 per cent of GDP with borrowing only for public investment in net terms over the course of the cycle.

   ii) Public sector deficit should be reduced to below 3 per cent of GDP and maintained at levels consistent with a 50 per cent debt threshold. Over time the definition of fiscal
balance should be extended to a broader balance sheet perspective to ensure no ‘off-balance sheet’ practice diminishes transparency.

36. Scottish Fiscal Commission: the resourcing and remit should be extended as policy competences are increased over time. Consideration should be given to its ability to measure the distributional impact of financial measures as well as the broader macro-economic and fiscal implications.

37. Budgetary Process Review and Implementation: the Finance Ministry should lead a budget process to ensure the fiscal transition is delivered effectively. The government’s strategic priorities should determine negotiations with spending departments along with high quality spending proposals and a rigorous ongoing review of them. Such a review and implementation should borrow from the best international examples and be implemented as an immediate priority and dovetail with the Standing Council on Scottish Public Sector Financial Performance. The outcome should be a systemic process of structured spending reviews as in countries such as Denmark.

38. Comprehensive Taxation Review: is recommended drawing on the best expertise and experience globally with a view to recommending reforms to improve simplicity, neutrality and flexibility. This review should also target a reduction in the inherited UK ‘Tax Gap’, the difference between actual and anticipated revenues. Given the nature of such a review should be designed to outlast any one Parliamentary term it would be beneficial if a cross-partisan approach could be achieved.

39. Debt Management Office: This should be established to a ‘best-in-class’ standard to manage the debt stock and issuance of debt.

40. Asset and Liability Management Office: In due course the DMO should be extended to have broader aggregate balance sheet responsibilities for financial and other asset holdings.

41. National Balance Sheet Review: a comprehensive inventory of assets and liabilities held by the public sector should be undertaken and valued transparently. As well as allocating responsibilities to their management including an assessment of whether the public sector remains the best possible owner of them. Such a process would be ongoing but with an initial reporting period of two to three years. A robust system for asset management and reporting should be established.

42. Deficit Reduction Policy: this should be established with a target of delivering the initial deficit target of under 3 per cent of GDP within 5 to 10 years. Public spending increases in transition should be limited to sufficiently less than money GDP growth to deliver this.
At trend rates of growth and inflation this would allow annual average cash increases of above inflation.

43. Transitionary Fiscal Stimulus a fiscal stimulus to growth should be considered and consulted on depending on the prevailing economic circumstances and the perspectives and price required by debt providers. It should be designed to enhance the ability of the economy and public finances to deliver the medium-term target.