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A YEAR ON …
A REPORT FOR THE HUNTER FOUNDATION

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FOREWORD

ONE YEAR ON…Sir Tom Hunter

Last year we set up scotlandseptember18.com to offer objective advice to voters on Scotland's YES-NO vote for independence. A year on we felt it important to review what was promised, what was delivered - or is in the process of being - what was missing and where we'd be had we voted YES.

Having voted NO after the historic "pledge" and establishment of the Smith Commission, will the new powers outlined to secure that vote be delivered? Yes and no.

Under new tax powers Scotland will take control of a further £ 17.4 billion of spending and need to find £ 2.7 billion for welfare support, so on tax Smith will be delivered assuming the Scotland Bill is, as is likely, passed. However on Welfare the Scotland Bill falls short on two counts; the Scottish Government can create new benefits but only for those that are being devolved, thus they cannot for example create a new benefit for the unemployed. Secondly the transfer of individuals from Disability Living Allowance to Personal Independence Payments is to go ahead even though these are to be devolved.

So Yes and No but underpinning all of this is the fact that as of today this is a one year settlement and there is no Barnett type formula (as yet) governing future payments; in other words we have an ongoing and painful expectation of labored negotiations unless a fair and equitable formula is agreed upon.

So far so good, well maybe. In effect this is a zero sum game and in fact Scotland may well be worse off economically. Whilst conferring new powers so we can look after our own policies there is no new money in the pot and unless magic powers are to be deployed the new funds require administering so costs, not savings will be the order of the day. For clarity the £ 17.4 billion will simply be deducted from the block Barnett payment.

As to the UK Government's pledge that the NHS in Scotland would be safe - it's vacuous as they have no authority over how the Scottish Government allocates funds to the NHS. In fact Scottish spending on NHS is 8% high per person versus the UK, however that percentage gap has been dropping year on year.

So where would our economy be had we voted Yes? The White Paper outlining the case for Independence estimated oil revenues consistently at £ 7.5 billion PA whereas after the oil price crash the OBR estimate for the next five years that its more likely to be £ 0.5 billion.

Nobody is blaming the Scottish Government for the drop but 65 000 jobs have been lost and our budget would be circa £ 7 billion short.

Clearly we would have faced either higher borrowings or increased austerity unless of course tax raising powers were deployed to offset the income loss. Regardless the numbers demonstrate the fragility of an oil based economy and underscore Scotland, and indeed the UK's, need to grow productivity, exports and entrepreneurship to build a more robust economic stability.

Are there any real conclusions one year on? Smith is in part being delivered; our NHS is as safe as the Scottish Government makes it and by delivering more powers we have reduced our overall budget more likely than not. In turn we sit in a bit of a beggar's muddle where the Scottish Government is negotiating with Treasury over settlements; a negotiation that will undoubtedly fuel consistent sniping that Scotland is not getting enough of its share. One thing Robert Smith may have missed was establishing an independent entity to manage that negotiation.

For me personally it's time to move on, move forward and use the powers we have. The population decided, politicians are democratically elected and should and must respect the decision of the voters.

We are all ambitious for Scotland and it's time for us to come together, put our differences aside and focus upon building a more prosperous, productive and fairer Scotland where opportunity prevails for all.

Professor David Bell is to be commended for this concise and informative summary of where we are one year on.

Yours aye

Tom

Executive Summary

- This paper assesses whether the "Vow" of the UK party leaders which promised new powers to Scotland has been upheld. It also speculates about what might have happened if the referendum had resulted in Scottish independence.

The "Vow"

- The tax powers coming to the Scottish Government will increase its revenue raising capability to £17.7bn out of a budget of around £30bn.
- The use of the tax powers will be constrained because VAT can only be assigned (due to EU regulations).
- Income tax offers the greatest potential for increasing revenues, but its use will be constrained by tax rates elsewhere in the UK and by the recent history where income tax rates have only moved in one direction – down.
- The size of the increase in tax revenues is significant, but there has not been an equivalent increase in tax flexibility.
- Income tax revenue will be the primary source of revenue to the Scottish Government,
- The proposed legislation on welfare powers for Scotland has diverged away from Smith on his welfare proposals in two important ways:
    - The power to create new benefits only applies to those areas where responsibility is to be devolved. This implies that the Scottish Government could create a new benefit for carers, but not for the unemployed.
    - The transfer of individuals from Disability Living Allowance to Personal Independence Payments is to continue even though these benefits are to be devolved. This is highly unpopular because the tests for PIP eligibility are widely thought to be unfair.
- The new welfare powers will add £2.7bn to the Scottish Government's budget.
- The part of the "vow" which pledged the safety of the Scottish NHS was not one that the UK parties could deliver because the NHS in Scotland is controlled by the Scottish Government. Public expenditure data suggest that Scottish spending on health has decreased year on year compared with England but still remains 8% higher per person.
- The "no detriment" principle means that, as the Smith proposals are implemented, the Scottish budget will be reduced by the amount it raises in taxes and increased by the amount it will spend on welfare.
- Whether, under the new powers, spending in Scotland on public services increases or decreases compared to the existing powers will depend on how well the Scottish economy performs compared with the rest of the UK and how willing the Scottish Government is to increase taxes.
- Overall the transfer of new powers will be at best a zero sum game with every likelihood - given the new administrative burden required to service some of those powers - that the Scottish Government will have more control over Scottish affairs but less money than under previous fiscal settlements to invest unless tax varying powers are deployed

HAD SCOTLAND OPTED FOR INDEPENDENCE

- In the long-run, it is impossible to predict how well or how badly the Scottish economy would perform under independence compared with remaining within the Union.
- In the short to medium term the collapse in the oil price would have posed a significant threat to the finances of an independent Scotland. The independence White Paper estimated oil revenues would be around £ 7.5 billion in 2016-17; the OBR now estimates that for the next five years that these will be around £0.5 billion.
- The collapse in the oil price is not the fault of either the UK or Scottish Governments. It is a function of changes in the global energy markets that have led to excess supply and sharp falls in government revenues in other resource rich economies such as Norway and Saudi Arabia.
- The fall in the oil price would have led to either an increase in taxation and/or a reduction in spending. An independent Scotland could, for example, eliminate defence spending, but that would still be insufficient to reduce its deficit to levels that could be considered manageable.
- Negotiations with the rest of the UK on the allocation of debt would be vitally important. On the one hand, the need to maintain good relations and not to impose costs on English and Welsh taxpayers might weight the argument in favour of accepting more debt; on the other, the fact that the debt is a legally liability of the UK rather than the Scottish Government would help the bargaining position of the Scottish Government.
- Debate on the currency would also be fraught. George Osborne argued that the rest of the UK would not accept a currency union. The other party leaders at the time agreed. The Governor of the Bank of England argued that monetary unions only work when supported by a fiscal union. The recent experience of Greece would be a salutary reminder of the consequences of failed monetary unions. Negotiation would likely focus on the extent to which Scotland would be willing to cede powers over tax and spending as the price of being part of the sterling area.
- The issue of pensions would arise for a newly independent Scotland in respect of the affordability of the state pension and public sector pensions if it was under pressure to reduce its budget deficit.
- There would also be complicated negotiations around eligibility for the state pension based on national insurance contributions made on both sides of the border and how to deal with cross-border occupational pensions. Some of this would have a negative effect on Scottish pension companies, which are an important part of Scotland's financial services industry.

1 Introduction

It's been a year since the referendum on Scottish independence. This is a good time to take stock of what's happened since, particularly in relation to the economy and economic powers. It's also worth speculating what would have happened to Scotland's economy if it had voted for independence.

2 What has happened?

Although the outcome was a "No" vote, the leaders of the main Westminster parties made a "vow" to the Scottish people that more powers would be delivered to the Scottish Parliament and that the NHS in Scotland would be safe. Has this vow been honoured?

The day after the referendum, David Cameron set up a commission under Lord Smith of Kelvin. His report, delivered in November 2014, recommended a raft of new economic and welfare powers for the Scottish Parliament. Then, in January 2015, the UK government produced draft legislation to implement Smith's proposals. This legislation is making its way through the UK Houses of Parliament and is likely to complete its journey before the end of 2015. Smith's main recommendations were in the areas of taxation and welfare. We look at these in turn.

New Tax Powers:

The Smith Commission proposed that the following tax powers be transferred to the Scottish Government:

- Complete control over income tax, other than the personal allowance and income tax on savings and investments (worth £10.9 billion in 2012-13)
- The money raised from the first 10 percentage points of the standard rate of VAT will be assigned to the Scottish Parliament. Since the standard rate is currently 20 percent, this means that Scotland will receive half of the VAT raised here (worth £4.4 billion in 2012-13).
- Control over Air Passenger Duty (worth £227 million in 2012-13)
- The ability to set the Aggregates Levy - a charge on commercial quarrying (worth £44 million in 2012-13).

Taken together, we estimate the value of the new taxes will be around £17.7 billion by 2016-17. Though this seems an impressive sum, these taxes do not give the Scottish Government a great deal of flexibility in reality. The main new revenue source will be income tax. But increases in income tax are highly unpopular in the UK. Their effect is felt most strongly by the "hard working families" that politicians are always trying to please or by high-earners who might consider reducing their labour input or moving to avoid high taxes.

Most recent Chancellors of the Exchequer, irrespective of party, have raised money from "stealth" taxes such as insurance premiums tax, which few people understand or have even heard of. Since 1979, the basic rate of income tax has never been increased. In fact, both Labour and Conservative Chancellors have cut the basic rate, which was 33% in 1979 and is now only 20%. It will be a brave decision for a Scottish Finance Secretary to reverse this trend.

Scotland will not control the VAT rate. Instead it will be assigned the revenues that are collected from the first 10p of the main VAT rate (currently 20p). The Scottish Parliament will not be able to change the VAT rate. This is prevented by EU regulations. However, increasing Scotland's growth rate will increase the purchases of goods and services in Scotland which in turn should raise VAT revenues. This way of assigning or sharing out tax revenues between different levels of government is very common in Europe and in federal countries, but is very rare in the UK, largely because central government has been unwilling to share tax-raising powers.

Because Smith's proposals cover a narrow range of highly visible taxes, the Scottish Government will not have access to the more subtle ways that recent Chancellors of the Exchequer have used to raise cash. Though there may be no reason in principle why Scotland should not increase income tax rates, Scottish Governments may not wish to put their popularity at risk by so doing.

The revenue from the new Scottish taxes will be added to the Scottish Government's budget. It will be able to spend them on any of the services that the Scottish Government provides.

Neither the media nor the population at large seem particularly interested in the fact that Scotland has already gained new tax powers. However, these will give a taste of things to come, particularly as far as income tax is concerned. They are the result of the Scotland Act 2012. The most important is the power to set the "Scottish Rate of Income Tax" (SRIT). This measure will give the Scottish Government a share of the revenue from each income tax band and will likely generate around £4.7 billion when it is introduced in 2016-17. In preparation for the introduction of SRIT, all income taxpayers normally resident in Scotland will be informed by HMRC of their liability to pay SRIT later this year. All employers will have to ensure that their payroll systems comply with SRIT. Some employers are taking advice on how to compensate employees should tax rates differ between Scotland and the rest of the UK.

The main difference between SRIT and the Smith proposal for income tax is that under Smith, it will be possible to set the basic rate, the higher rate and the additional rate separately rather than having to move them all together. Under Smith the higher rate can be increased without affecting the basic rate. Nicola Sturgeon has suggested there will be no increase in SRIT next year. Again, following our earlier discussion, this may be a recognition of the potential unpopularity of increasing income tax rates. Our estimate is that a 1p increase in SRIT would raise around £450m.

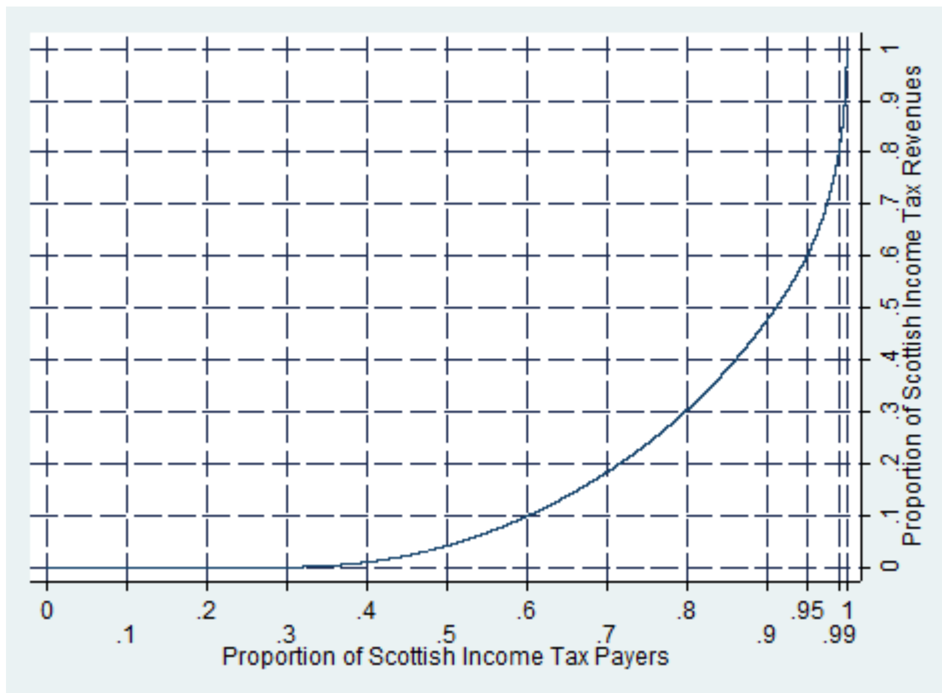
The Scottish Government will not be able to set the personal allowance for income tax; neither will it receive income tax on savings and investment. There are practical issues with both these aspects of income tax. Firstly, there is a strong interaction between working age welfare benefits and the personal allowance. Since working age benefits are largely being reserved by the UK government, there is a case for also retaining the personal allowance. Secondly, the taxation of savings and investments is extremely complex in a highly integrated capital market. Given that the revenues involved are relatively small, there is a case on costs grounds for taxing these at a UK level.

Some have argued that Scotland should move towards a more Scandinavian tax and welfare system. Smith's proposals would allow this to happen, but in a limited way. The power to change the size of income tax bands and their rates would permit Scotland to lift the highest rate of income tax from its current 45p to 56.9p, the highest rate that applied in Sweden in 2014. Again, there may be a concern that this could have a negative effect on the economy given that the UK has a highly integrated labour market. Taxpayers might move away or not come to Scotland if they feel that tax rates are excessive. At present, there is insufficient information on which to base a sensible prediction as to how taxpayers may react. Because of this, it would be no surprise if the Scottish Government adopted a very cautious approach if there was pressure to move towards a more Scandinavian system.

Income taxes in Sweden differ in a further way from that in the UK. They are allocated in fixed proportions to county councils and to municipalities. This means that these bodies are less dependent on grants from central government and are more independent than is the case in Scotland. While the Smith Commission suggested that the Scottish Government looks to the possibility of further devolution of tax power *within* Scotland, it made no concrete proposals. An opportunity missed?

We know that in Scotland the amount of income tax paid varies widely across taxpayers: some pay a lot; most pay very little. This is best explained in a diagram. Figure 1 shows the proportion of total income tax paid by Scottish taxpayers ordered from those with least income to those with most income. So the diagram shows that the first 60 per cent of Scottish income taxpayers pay only 10 per cent of Scotland's total income tax revenues. The first 90 percent of Scottish taxpayers contribute just under 50 per cent of total income tax revenue.

Figure 1: Proportion of Scotland's Income Tax Revenue Paid by Scottish Taxpayers



Source: HMRC Survey of Personal Incomes

This means that the richest 10 per cent of taxpayers pay more than 50 percent of income tax revenues. And the top 5 per cent of tax payers (those to the right of 0.95 in Figure 1) contribute 40 per cent of Scottish tax revenue. There are around 2.6 million taxpayers in Scotland – 5 per cent of these comprise around 130,000 people. Income tax will be the Scottish Government's main future revenue source, but a large proportion of that revenue is dependent on a relatively small number of taxpayers. So how this group reacts to changes in tax rates will be very important for the health of the Scottish economy.

The income tax power is the main fiscal element of the Smith Commission proposals. In theory, it gives the Scottish Government control of the largest source of tax revenue. But, like all governments, it cannot change the structure of this tax without taking into account its effect on the economy. It goes without saying that it will also take account of any such changes on its own popularity. Had Scotland become independent, the same considerations would apply.

New Welfare Powers:

Smith recommended that the Scottish Government should be given new powers over welfare covering:

- Attendance Allowance, Carer's Allowance, Disability Living Allowance, Personal Independence Payment, Industrial Injuries Disablement Allowance and Severe Disablement Allowance. These benefits target carers, the disabled and those who are ill.

- Cold Weather Payment, Funeral Payment, Sure Start Maternity Grant and Winter Fuel Payment. These benefits are part of what is known as the Regulated Social Fund.

- Discretionary Housing Payments

It also recommended that the Scottish Parliament should have the power to create new benefits and to top up existing benefits.

Taken together, these benefits will be worth around £2.7 billion in 2015-16. The Scottish Government will have to find the money to pay for these.

Has the UK government delivered on Smith's welfare proposals? The Scotland Bill differs from Smith in two important ways:

- The power to create new benefits only applies to those areas where responsibility is to be devolved. This implies that the Scottish Government could create a new benefit for carers, but not for the unemployed.
- The transfer of individuals from Disability Living Allowance to Personal Independence Payments is to continue even though these benefits are to be devolved. This is highly unpopular because the tests for PIP eligibility are widely thought to be unfair.

While the welfare benefits mentioned in Smith will be transferred to the Scottish Government, the Scotland Bill does differ in significant ways from the Smith Commission's direction of travel.

Taken together, the new tax and welfare powers give the Scottish Parliament control of about 56% of government spending *in* Scotland or *for* Scots (UK defence spending is not generally in Scotland, but is

counted as being for Scots). The Scottish Parliament will also control around 38% of tax revenues raised in Scotland. These proportions are very high compared with most territorial governments within larger nation states. After the Scotland Bill is passed, Scotland will have more fiscal freedom than almost all territorial governments in other countries.

However, the design of the new powers does not make it any easier for Scottish taxpayers to understand where their taxes are going and what they are paying for. The Smith Commission did not propose that new Scottish taxes be earmarked for particular services. As a rough guide, £17.7 billion is enough for the Scottish Government to pay for the NHS in Scotland, the police and criminal justice system and the new welfare powers that are coming to Scotland.

Other services provided in Scotland such as education, transport and the remaining welfare bill which covers the state pension, housing benefit and job-seekers allowance will be paid by taxpayers in the rest of the UK and by the remaining taxes paid by Scots. These include the other half of VAT, national insurance, fuel and excise duties. These sources of revenue will also be used to support services that are common across the UK - such as defence, international aid and, most importantly in value terms, interest payments on the national debt.

The National Health Service

The "vow" also mentioned that the NHS would be safe if the Scottish electorate voted "No". Has this been achieved?

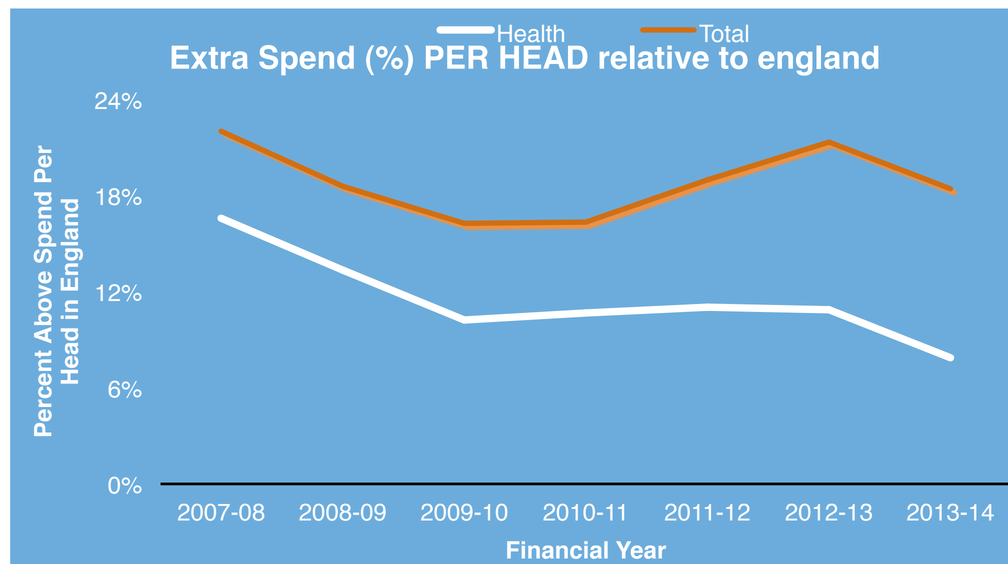
This is a difficult question to answer. The UK government does not control health care spending in Scotland. It has no say over how the Scottish Government sets its budget. The size of its budget depends on the taxes it gathers and its block grant from Westminster. So how the UK government can guarantee the safety of the NHS in Scotland is a bit of a puzzle. Perhaps the "vow" was meant to be interpreted as ensuring the safety of NHS funding in Scotland through the continuation of the Barnett Formula, which determines the size of Scotland's block grant.

But it's not entirely clear that the NHS has been safe in the Scottish Government's hands. The Institute for Fiscal Studies showed that from 2002-03 to 2011-12 spending per person on health grew more slowly in Scotland than in the UK as a whole[1]. Since the Scottish Government has almost complete control over health spending in Scotland, slower growth in health spending is its responsibility.

Do recent data confirm this IFS finding? Figure 2 shows the difference between health spending per head in Scotland and in England expressed as a percentage covering the period 2007-08 to 2013-14. It also shows the difference in spending per head on all public services. In 2007-08, Scotland was spending 17% more per person on health than in England. By 2013-14 this gap had fallen to 8%.

[1] Institute for Fiscal Studies (2013) "Government Spending on Public Services in Scotland: Current Patterns and future issues", Accessed at: http://www.ifs.org.uk/bns/bn140.pdf

Figure 2: Extra Spending per Head in Scotland Relative to England: Total and Health



Source: Public Expenditure Statistical Analysis 2013 and 2015

Thus, the most recent data on public spending seem to confirm the IFS conclusion that spending on health in Scotland, while still above that in England, has been growing more slowly. The "vow" tried to reassure the Scottish public about NHS spending in Scotland, but that was a commitment that the Westminster parties could not really make.

Will the new tax and welfare changes mean that the Scottish Government has more to spend?

After the Scotland Bill 2015 is passed, the Scottish Government will have new sources of revenue from the taxes it now controls. Does that mean it will have more to spend? The answer is probably no, at least for the first few years.

When Scotland raises its own taxes, taxes collected by the UK Government will fall by the same amount. So the block grant, which is the annual payment from the UK to the Scottish Government, will be cut since the UK government will have less tax revenue to spend on services for the people of England, Wales and Northern Ireland.

The size of the cut in the first year will be equal to the amount raised by Scotland's new taxes. In the language of the Smith Commission, there will be "no detriment" to either Scotland or the rest of the UK. So the Scottish budget won't change.

After the first year, the change in the block grant will be "indexed" to some external factor, most likely the growth of tax revenues in the rest of the UK. This will allow the Scottish budget to increase in size if the Scottish Government introduces policies that make Scotland's economy - and therefore its tax revenues - grow faster than the rest of the UK. If the Scottish economy fails to keep pace, the Scottish Gov-

ernment's budget will fall. Thus, the Scottish budget will face a new set of risks and rewards. It will be taking on much greater responsibilities for raising cash to pay for Scotland's public services. Of course, if Scotland had voted for independence, it would be fully responsible for revenue raising.

The Fiscal Framework

Forecasting tax revenues is perhaps more of an art than a science: they are rarely correct. Some taxes are easier to forecast than others. Income tax is relatively easy since most people's income tends to be stable from year to year. But due to its size a small error in income tax forecast can mean a large change in revenues. At the other end of the predictability scale is revenue from oil and gas exploration as we shall see shortly.

The possibility of forecasting errors has two important implications. First, the Scottish government will have to be able to borrow to cover such errors. Having to close a hospital or a school because there isn't enough money in the kitty is not a recipe for political popularity. But where should the Scottish Government be able to borrow from and how much? One argument is that it should be allowed to borrow as much as it likes and take the consequences if it makes a mistake. But some argue that lenders will always assume that the UK will bail Scotland out if it has difficulty repaying its debts. This will make lenders more willing to lend and to offer lower interest rates. Those that argue that this would constitute an unfair risk for the rest of the UK suggest that Scottish borrowing should be limited by the Treasury to what seems a plausible range given the ups and downs of tax revenues. Another argument they deploy is that Scottish debt will count against UK debt for a number of internationally recognised measures. They would not wish international investors to take a more negative view of the UK due to the knock-on effects of Scottish debt.

Second is the question of who makes the forecasts. Politicians tend to argue that all is well with the economy and the future is bright, even when this is clearly untrue. There is therefore a need to have a body outside government charged with producing forecasts for the economy and tax revenues. In the UK, this task is carried out by the Office of Budget Responsibility. The Scottish Government has set up the Scottish Fiscal Commission to produce forecasts for the Scottish economy. However, questions have been raised about how well it is being resourced, given the importance of its task.

Conclusion

The "vow" led to the Smith Commission which in turn has led to the legislation that is currently making its way through the UK Parliament. The main focus of this legislation is on tax and welfare powers. However, although the legislation largely reflects what Smith proposed, it does not make a very coherent package. The Scottish Government will now have to confront not only a set of risks and potential rewards, but also the realities of the economic implications of the tax and welfare decisions it takes. These may well lead to a more cautious approach to changes in tax and welfare than some may expect. Would the same have been true under independence? We consider this in the next section.

3 Suppose Scotland had voted for independence? What might have happened?

In the run-up to the referendum there were times when it appeared possible, or even likely, that Scots would opt for independence. So what might have happened to the Scottish economy if the "Yes" campaign had won?

It is impossible to forecast what will happen to the Scottish economy in the long run either under independence or as part of the UK. Economic growth will depend on the productivity of Scottish workers. More rapid productivity growth means faster growth in tax revenues. In turn these tax revenues can be used to support Scottish public services. Productivity growth tends to be the result of long run factors such as education, entrepreneurship and capital investment.

Realistically, forecasts about the economic implications of independence can only apply to the short or medium run.

Would an independent Scotland be fairer and less unequal? Again almost impossible to predict. It isn't just taxes and benefits that determine levels of inequality.

There would undoubtedly be short term costs of setting up the institutions that an independent country needs. For example, Scotland would have to make arrangements with other countries as to how to tax individuals that spent some time in Scotland and some time in another jurisdiction. These "double taxation" treaties would take several years to set up. Costs would be incurred by the private sector as well as by government. Add to this a benefits system, all forms of market regulation and a central bank. Very difficult to put any sensible price on these because the costs will depend on decisions about the precise role of such institutions.

Currency

If Scotland had become independent, would it still be using the pound? There is nothing to stop Scots using the pound. There are several countries outside the USA that use the dollar as their main currency.

There would however be a problem for banks based in Scotland. Banks need a "Big Brother" - a central bank - to whom they can run if they are short of cash. And to be confident about using banks, depositors like to have their money insured - deposit insurance. All of this would be very complicated if Scotland had no formal agreement with the rest of the UK about using the pound.

Some argue that a central bank is unnecessary. Banks should just go bust if they can't make good lending decisions. This does however create a problem for depositors. They won't want to put their money in a bank if they think it might collapse and they would consequently lose their deposits. Scotland had free banking (no central bank) between 1716 and 1845, so there is historical precedent.

However, there is debate as to whether it was successful. Interestingly, the potential introduction of new digital currencies may offer the possibility of returning to a less regulated banking system. But, for the foreseeable future, an independent Scotland could not successfully deviate from the internationally accepted structures of banking organisation and regulation.

Being formally part of the "sterling area" would require the agreement of the UK government. George Osborne argued that such an agreement would not happen. He has been re-elected. Changing this policy would be politically very difficult for him. Mark Carney, Governor of the Bank of England, argued that a successful currency union would require banking union and "shared fiscal arrangements" - agreements

about how taxes are set. This would be a severe problem for Scotland where one of the justifications for independence is the desire to set taxes differently from the rest of the UK.

If no arrangement could be reached, Scotland would probably have had to set up its own currency, at least in the short run. In the medium to long term, it could apply to join the euro, but recent events suggest that might be a mixed blessing.
The issue of currency was a critical factor in the referendum. Our survey of voters showed that they were particularly concerned about losing the pound and saw that as the most important risk that voting "Yes" would entail.

Debt

At the start of 2015, UK government debt was £1.56 trillion. Scotland's population share (8.4%) of this debt is £131 billion. Scotland's estimated GDP in 2014, including oil, was £153.5 billion. Therefore, this level of debt would amount to 85% of GDP.

In 2016-17, the UK Government will spend £51 billion on the interest on this debt. Scotland's population share would be £4.3 billion. To put this in perspective, this is around £500 million more than is spent on Scotland's universities and colleges by the Scottish Government.

If Scotland had become independent, the size of the debt that Scotland took on would probably have been the major element in the negotiation with the Westminster Government. None of the debt is currently assigned to Scotland: it is all UK Government debt. Creditors expect the UK government to pay the debt as it becomes due. Therefore, the Scottish government would have to pay the UK government who in turn would pay the creditors. The fact that none of the debt is "Scottish" at present would clearly strengthen the Scottish government's hand in the negotiation.

The UK Government would probably argue that Scotland accepting a population share of the debt would be a fair outcome. A case might be made for a smaller total based on the positive contributions that North Sea oil revenues have made to the UK Exchequer in the last four decades. A case could be made for a larger total based on the long history of higher public spending per head in Scotland. It is perhaps unlikely that an amicable solution would be found on such an important issue even though this might have negative consequences for Scotland in terms of future access to capital markets.

Pensions

The Scottish Government argued that after independence it would maintain the "triple lock" on the state pension. This means that the state pension will increase each year by either 2.5% or the rate of increase of earnings or the rate of increase of prices, whichever is the biggest. This is exactly the same commitment that the UK government has made.

Scotland has lower life expectancy than the UK but in future decades will have a larger proportion of its population aged over 65. The state pension would therefore account for a larger share of public spending in an independent Scotland than in the rest of the UK, requiring some combination of higher productivity, higher taxes or reduced spending on other government priorities if the triple lock pension commitment is to continue to be met.

Commitments to public sector pensions would also have to be met. In the 2016-17 draft budget, the Scottish Government has set aside £3.9 billion to meet commitments to public sector pensions. These are likely to rise in the future as increasing numbers of individuals previously employed in the public sector retire. But these commitments will have to be met whether Scotland is independent or not.

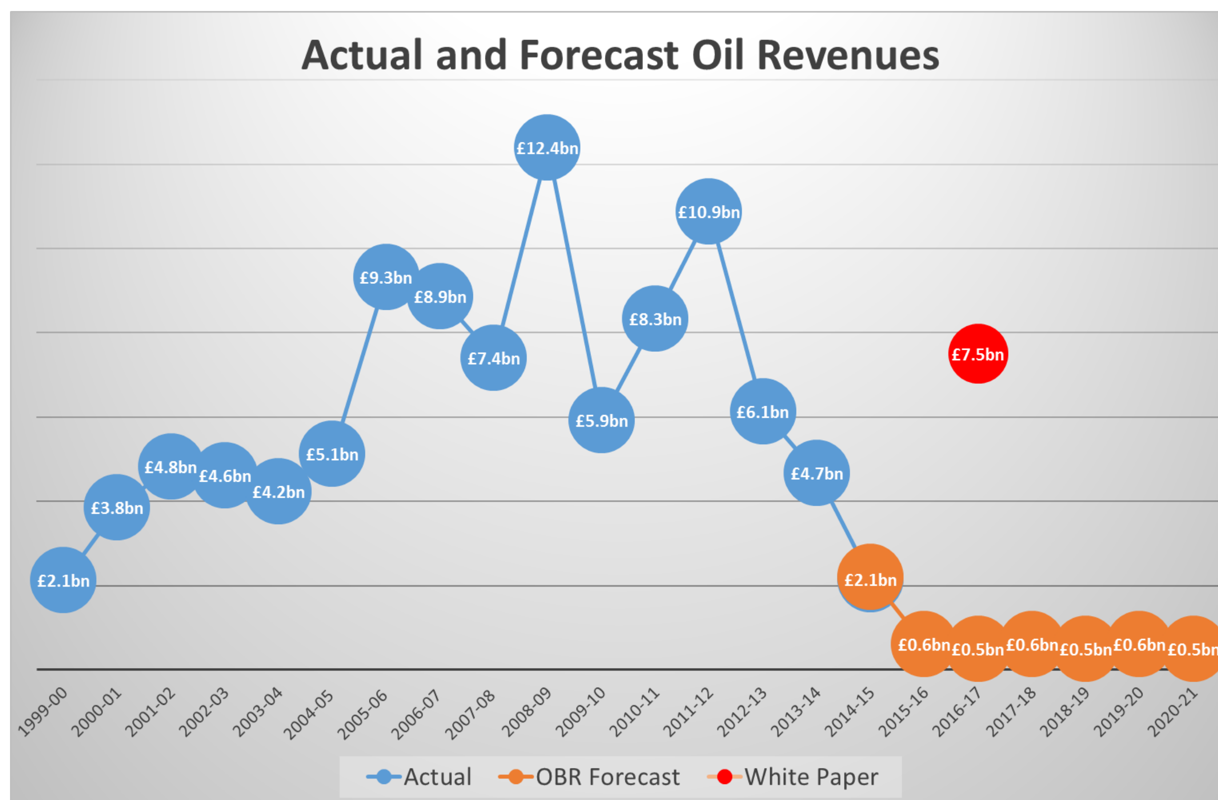
On the other hand, arrangements for private sector pensions would also have to be considered as a matter of urgency if Scotland became independent. The possibility of having a different regulatory regime for pensions in Scotland would be a matter of concern both to policyholders and to the pensions industry in Scotland. Pensions are a significant component of Scotland's financial services sector: regulatory risk would be potentially damaging to the competitiveness of Scottish pension providers with a significant proportion of their market in the rest of the UK.

What happened to oil and does it matter?

Since the referendum, the price of oil has collapsed. As I write, the price is hovering around $48 per barrel. Last September it was around $100 per barrel. The fall in the oil price would have had a negative effect on an independent Scotland's balance sheet just as it has in oil-dependent countries such as Norway and Saudi Arabia.

The fall in the price of oil is not the fault of the Scottish Government. Neither can any of the blame be attached to the UK Government. It is the outcome of global events. There has been an increase in supply, partly caused by increased production in Saudi Arabia and by the success of the US fracking industry in extracting gas and oil from shale. The slowdown of the Chinese economy has weakened the demand. The glut of oil on world markets has led to a significant decline in its price.

Figure 3: Actual and Forecast Oil Revenues the White Paper and the Office of Budget Responsibility



Sources: HMRC (2015) Tax Receipts, OBR (2015) Tax Forecasts, Scottish Government (2013) "Scotland's Future"

The current and expected effect on North Sea oil revenues has been dramatic. Between 2003-04 and 2013-14, Scottish oil revenues averaged £7.6 billion. The White Paper which made the case for independence included a forecast of oil revenues made in 2014. The middle of the forecast range was £7.5 billion - no surprise given the history of oil revenues in the previous decade.

But the collapse in the oil price has led to a drastic downward revision in estimates of the value of North Sea oil to the UK and Scottish economies (see Figure 3). The latest forecast from the Office of Budget Responsibility (OBR), which has had a track record of being overly optimistic about oil revenues, suggests that the annual contribution from North Sea oil to tax revenues is unlikely to exceed £0.6 billion for the next six years.

The long-run future for oil prices? Undoubtedly they will increase above current levels. But when? Recent events seem to suggest that supply is going to exceed demand for the foreseeable future. The implication is that the return to higher prices is not yet on the horizon.

Would an independent Scotland have had to cut public spending?

Neither side in the referendum campaign could ignore the U.K.'s difficulty in balancing its budget. Both tried to paint the most optimistic picture of the Scottish economy. The "Yes" campaign described policies that were intended to show how Scotland could come close to balancing its books. The "No" cam-

paign argued that Scotland faced a significant fiscal deficit in the short run and would have no option but to cut public spending in order to prevent its debt rising unsustainably.

Let's start from the estimates of Scotland's finances in the White Paper[2] on Scottish independence and add some new information that has become available since the referendum. Table 1 shows the calculations:

Table 1: Scotland's Public Finances in 2016 – 17

	2016-17
Total government spending	£63.7bn
Debt interest (population share)	£4.3bn
Onshore receipts	£56.9bn
Offshore receipts	£0.5bn
Net fiscal balance	-£10.6bn
Deficit as share of GDP 2016-17	
Scotland	-6.4%
UK	-2.2%
Difference between Scotland and UK	
Percent	4.2%
Nominal	£7.0bn

The White Paper estimated that spending in Scotland would be around £63.7 billion in 2016-17. This estimate was largely based on UK spending plans, including deficit reduction measures.

We now know that a population share of debt interest charges would cost an independent Scotland around £4.3 billion in 2016-17. However, there has been a drastic reduction in estimated oil and gas revenues to £0.5bn for 2016-17. As mentioned earlier, the fall in oil revenues is neither the UK nor the Scottish Government's fault, but does illustrate how volatile resource-based taxation can be. This would leave the Scottish public finances with a shortfall of around £10.6 billion, which would amount to around 6.7% of GDP. The OBR forecast is that the UK deficit in 2016-17 will amount to 2.2% of GDP. This leaves a difference of 4.2% between the Scottish and UK fiscal deficits - equivalent to £7.0 billion. This is reasonably close to recent estimates made by the Institute for Fiscal Studies[3].

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[2] Scottish Government (2013) Scotland's Future: Your Guide to Independence, Page 75

[3] Institute for Fiscal Studies (2015) Full Fiscal Autonomy Delayed? The SNP's Plans for Further Devolution to Scotland Accessed at: http://www.ifs.org.uk/publications/7722

Running such a large deficit would clearly be a problem for a newly independent Scotland. Would it need to cut public spending? There are two ways that it could make an immediate impact. Firstly, it could reduce spending on Scotland's defence to negligible levels: the spending figures in Table 1 implicitly assume that Scotland would spend £3 billion on defence. It could also refuse to pay a population share of the interest on the UK debt, although this might have serious repercussions later.

If these mechanisms didn't work, then Scotland might have to pay premium rates to borrow on international capital markets, given that it has no credit history on these markets. Creditors would demand a plan from the Scottish Government for reducing the deficit. Would this mean austerity? Quite possibly. But of course an independent Scotland could choose to change the balance of deficit reducing measures compared with the UK, whose strategy for closing the budget deficit places the "heavy lifting" on spending cuts rather than on tax increases.

Conclusion

There is little point in making long run forecasts for the economic prospects of an independent Scotland. They are simply unknown. Clearly they would depend on the extent to which the economic policies followed by an independent Scotland offered opportunities for business and for workers. They would also depend on whether Scotland's policies were more investor friendly than those of competitor nations. But in the short run, it seems likely that Scotland would face fiscal difficulties and would be forced to rebalance the economy by introducing some combination of lower public spending and higher taxes.