

Scotland's Economy: the case for independence

A hand holding a magnifying glass over the word 'ECONOMY'. The magnifying glass is positioned over the word, which is written in a bold, white, sans-serif font. The background is a blue-tinted image of the Scottish flag (Saltire) with a hand holding the handle of the magnifying glass on the right side.

ECONOMY

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Foreword



For centuries Scotland has been at the heart of global economic innovation.

Thanks to the ingenuity of Scots, people across the world can watch television, make a telephone call and use PIN numbers.

Our deeply-ingrained commitment to education and science has led to the discovery of penicillin, the development of insulin and a host of other medical advances that have benefited humanity.

We have produced some of the greatest entrepreneurs the earth has ever known and we are home to many world-beating companies.

Our feats of engineering – from the Forth Bridge in the 19th century to the Falkirk Wheel in the 21st – are world renowned.

Today we have significant comparative advantages in green technology, renewable energy, life sciences, quality food and drink, oil and gas and the potential across our economy to secure a more prosperous future for the people of our country.

And as the Balance Sheet annexed to this paper shows, we have generated more tax receipts per person than the UK for every one of the last 30 years. We are in a fiscally stronger position than the rest of the UK.

However, Scotland today faces a paradox. Despite our significant array of human, financial and natural resources we are not as prosperous a country as we should be.

Our long term growth rate has lagged behind the UK as a whole.

Our economic performance has also trailed other countries of a similar size to Scotland.

The gap between rich and poor has been widening, with implications for both individual and national well-being.

And, while unemployment in Scotland is currently lower than in the UK we lack a full set of economic levers to create more – and better paid – jobs.

Our economic strengths - our ingenuity, our natural resources and our advantages across a range of growth sectors - mean that we should be confident about our economic prospects as an independent country.

The Scottish Government asked a group of eminent economists - The Fiscal Commission Working Group - to produce a report on the design of a macroeconomic framework for an independent Scotland.

The group reported: "By international standards Scotland is a wealthy and productive country. There is no doubt that Scotland has the potential to be a successful independent nation."

But a one-size-fits all economic policy for the UK, with all the key decisions taken in Westminster deprives Scotland of the levers it needs to set our economy on a path to higher growth and employment.

It is only by being independent that we will be able to realise our potential.

The proposition at the heart of this document is thus not just that Scotland can afford to be independent. It is that independence is an essential step if we are to build a better, more prosperous and fairer country.

Next year people in Scotland will be asked: "Should Scotland be an independent country?"

The Scottish Government believes fundamentally that decisions about Scotland should be taken by the people who care most about Scotland – those who live here.

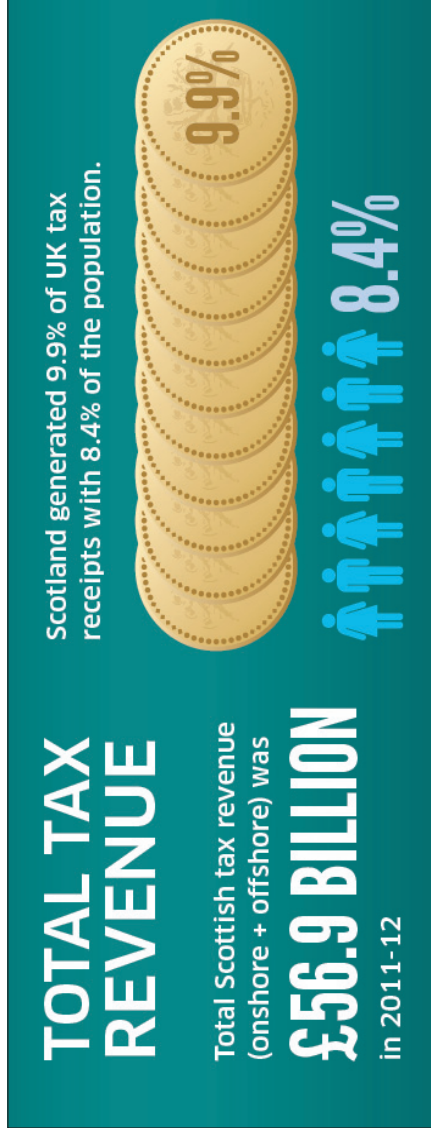
In an increasingly competitive world, it is necessary to take a full set of decision-making powers to allow us to build on our comparative advantages and tackle our legacy of inequalities.

I hope this paper will make an important contribution to the debate that will take place in the build-up to the historic referendum on September 18, 2014.

A handwritten signature in black ink, appearing to read 'Alex Salmond', with a small mark at the end.

Alex Salmond MSP
First Minister for Scotland

Scotland's Economy Today



Introduction

In the independence referendum on September 18, 2014, Scotland will be faced with a choice between two futures.

A Yes vote will mean endorsing the view that people who live here - equipped with the powers that other countries take for granted - will do a better job of running Scotland than politicians in London.

If a majority vote Yes, Scotland's future will be in Scotland's hands.

A No vote will mean Westminster retaining control over key decisions that affect life here in Scotland.

This paper makes four key arguments that are at the heart of the economic case for independence:

1. Scotland can afford to be an independent country. As even those who argue against independence now acknowledge, the viability of an independent Scotland is not in any doubt.

The Prime Minister, David Cameron, has said:

“Supporters of independence will always be able to cite examples of small, independent and thriving economies across Europe such as Finland, Switzerland and Norway. It would be wrong to suggest that Scotland could not be another such successful, independent country.”

The former Chancellor, Alistair Darling, has said:

“The question is not whether Scotland can survive as a separate state. Of course it could. The real question is what is best for Scotland's future.”

Section 1 and the Balance Sheet attached at Annex A set out Scotland's strong financial foundations. They show Scotland in a stronger fiscal position than the UK as a whole over the last five years to the tune of £12.6 billion.

2. Scotland has enormous potential. Our natural resources, our world class university sector, our highly educated population, our strong national commitment to education, our global reputation, our strong growth sectors and our commitment to remaining part of the EU and the single market give us strong prospects for growth.

Section 2 sets out the strength that Scotland has in life sciences, tourism, creative industries, digital and ICT, energy, renewable energy, low carbon technologies, food & drink, financial and business services.

It makes the case that, equipped with the economic powers that other countries take for granted, there are few countries that should be more confident about their future than Scotland.

3. Section 3 addresses Scotland's future within the UK. It is clear that the status quo is not working. This section builds on the conclusions of the Fiscal Commission Working Group report and covers our long term growth rates; our economic performance compared to other similarly sized countries; the geographic imbalance within the UK that holds Scotland back; the growing income inequality that has a negative impact on growth and prosperity; and the weaknesses of current and past UK economic policy. It makes the case that Scotland is being held back economically in the Westminster system, and that the consequences of not becoming independent will be damaging for our economy in the future.

4. The powers of independence will better enable us to harness our economic strengths and fulfil our economic potential. Section 4 will set out the evidence that small countries have been particularly successful in recent decades. It will also set out the limitations of the economic powers that the Scottish Parliament currently has (and those it will get under the Scotland Act 2012.) It will set out why it is the best option for both Scotland and the Westminster government to agree to share the pound. And it will list the substantial additional economic powers that an independent Scotland will gain.

A competitive economy and a fairer society: two sides of the same coin

We believe our economy must be both more competitive and fairer. Indeed, we believe tackling inequalities will enhance our competitive position by increasing opportunity and participation.

In a report published in 2011, the OECD concluded:

“Income inequality among working-age persons has risen faster in the United Kingdom than in any other OECD country since 1975.”¹

The Fiscal Commission Working Group was clear about the impact of the growing gap between rich and poor:

“Such patterns of inequality will continue to have a negative impact on growth and prosperity over the long-term.”²

The Westminster system has also generated another stark inequality: the gap between the best and worst performing areas of the UK – a gap which appears to be bigger than other comparable countries – with London becoming increasingly dominant.

In these circumstances it is the Scottish Government’s contention that a “one-size-fits-all” economic policy has neither worked in the past nor is it the best prescription for the future.

It is essential to recognise that policies that are appropriate for a larger economy will often not be appropriate at all for a country of Scotland’s size.

The UK government explicitly recognised this fact in its recent paper on currency and monetary policy, when it said:

“The dynamics of small economies are inherently different from larger economies such as the UK.”

This paper is not designed to be a policy manifesto. However, it will highlight some of the key policy levers that an independent Scotland - acting at all time in accordance with the principles of fiscal discipline - could use to tackle income inequalities, create meaningful and rewarding employment, counterbalance the gravitational pull towards London and to stimulate growth in our key sectors and in the economy as a whole.

¹ <http://www.oecd.org/els/soc/49170234.pdf>

² Fiscal Commission Working Group Report <http://www.scotland.gov.uk/Resource/0041/00414291.pdf>

Economic policy-making: six examples of why Westminster isn't working for Scotland's economy:

- The failure to establish an oil fund for future generations. Norway has been able to use its oil wealth to establish an oil fund, now worth close to £450 billion, equivalent to approximately £90,000 per person. Using reasonable assumptions about investment returns the Fiscal Commission Working Group estimated that if an independent Scotland had been able to invest the net fiscal surpluses achieved since 1980 it would have accumulated assets equivalent to between 62% and 84% of GDP.

- The decision to allow the UK economy to engage in, in the words of the current UK Business Secretary, a “massive boom in credit and debt expansion” which allowed a “very dangerously unstable position” to develop. Over the period 1996 to 2007, household indebtedness in the UK rose from 103 per cent of gross disposable income to 176 per cent in 2007 – a rise of 71 per cent – the highest level of all G7 economies. Although Italy saw a steeper rise over that period, - of 80 per cent - its household indebtedness as at 2007 was significantly smaller at 70 per cent of gross disposable income.³

It should be noted that households in Scotland have historically had a relatively stronger savings ratio compared to the UK as a whole.

- The decision to allow income inequality to grow dramatically. Research, based on United Nations findings, has shown that the UK has the fourth highest level of income inequality among the world's richest countries with a population of one million or more.⁴

- The decision to concentrate so much economic activity in London and the South-East of England, which, according to the current Prime Minister, is “fundamentally unstable and wasteful”.

- The decision to impose a policy of austerity on Scotland, which according to the former Chancellor, Alistair Darling, is causing “immeasurable damage” to the economy.

- The decision to cut capital spending. In this paper the Scottish Government has modelled that had capital spending been maintained at 2009-10 levels in real terms it would have supported an additional 19,000 jobs.

³ OECD Factbook 2010: financial crisis. Indebtedness of households as ratio of gross disposable income

⁴ <http://bellwether.metapress.com/content/m10m3736514222g5/fulltext.pdf>

Section 1: Scotland's Foundations

Scotland's Economy

The Fiscal Commission Working Group (FCWG) analysis in its report on Scotland's macroeconomic framework concluded that:

- By international standards Scotland is a wealthy and productive country;
- Even when North Sea oil is excluded, GVA per head in Scotland is 99% of the UK average and the highest in the UK outside London and the South East;
- However, over the last 30 years Scotland has grown more slowly than the UK as a whole, and;
- Many countries of a similar size have made use of the full range of fiscal and policy levers to perform more successfully.

At an aggregate level, the Scottish economy performs strongly on key indicators. However in certain areas, in particular in relation to the long-term drivers of growth and business development, Scotland has lagged behind many of its competitors and there is scope for improvement.

In terms of performance within the UK, the most recent data shows that, in terms of GDP per capita⁵ in 2011, Scotland was positioned as the third highest nation or region in the UK – behind London and the South East. Adding Scotland's illustrative geographical share of North Sea output increases Scottish GDP per head to around 118% of the UK average.

Scotland also performs well compared to the rest of the UK on other key economic indicators, such as the labour market, with unemployment currently lower in Scotland than in the UK.

However, although we perform well within a UK context, we lag behind many of our international competitors in key areas.

For example, whilst productivity levels in Scotland are now broadly the same as the UK average – and despite it being estimated that with an illustrative geographic share of North Sea output, Scotland would be ranked 8th in terms of GDP per capita in the OECD⁶ - a gap remains between economic development in Scotland and the top-performing OECD member countries. In productivity for example, we currently rank 17th in the OECD.

Even with an unprecedented eight years of austerity planned by the UK Government for between 2010-11 and 2017-18, net debt is forecast to reach over 85% of GDP.

⁵ Data in terms of GDP per capita being the most widely recognised measure of relative living standards

⁶ <http://www.scotland.gov.uk/Topics/Economy/Publications/GDP-Per-Capita>

The UK economy faces a number of significant challenges. There is an ageing population which will put further pressure on public resources. The economic model put forward by successive UK Governments – and its reliance upon finance and growth in London and the South East – has made the UK economy less resilient to economic shocks. The UK has recorded a current account deficit in its balance of payments in every year since 1984, and since January 2007 the trade-weighted value of Sterling has fallen by 24%.

Independence would provide the tools and opportunity to boost Scotland’s economic performance, to compete on a level playing field with other countries and to create greater opportunities for all.

Table 1a. Key Facts: Scotland and the UK

Gross Domestic Product per capita (£)	Scotland	UK
Onshore Only	23,391	23,673
Including a Geographical of Extra – regio (UK continental shelf)	28,344	24,168
Unemployment Rate (%) Jan – Mar 2013	7.3%	7.8%
Employment Rate (%) Jan – Mar 2013	71.8%	71.4%
Net Fiscal Deficit (%age of GDP) 2011/12	5.0%	7.9%

Sources: Scottish National Accounts Project 2012 Q3; UK National Accounts 2012; Labour Force Survey; UK Regional GVA 2012

Scotland is home to a skilled workforce. This is one of the reasons why it has become such an attractive location for inward investment.

Table 1b: % of Population aged 16-64 with SVQ Level 3 or above Qualifications

	2004	2008	2012
Scotland	58.7%	59.8%	63.7%
England	48.7%	50.2%	57.7%

Source: ONS Annual Population Survey

Table 1c: % of Population aged 16-64 with SVQ Level 4 or above Qualifications (HNC/HND/Degree Level Qualifications)

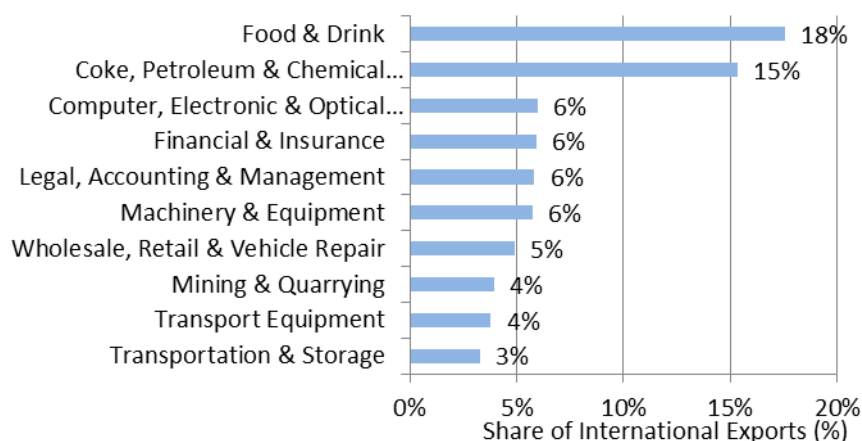
	2004	2008	2012
Scotland	30.3%	33.4%	38.8%
England	26.0%	28.5%	34.6%

Source: ONS Annual Population Survey

Scotland: A Trading Nation

- In the Ernst & Young UK Attractiveness Survey, Scotland has been in the top two nations and regions in the UK for inward investment jobs in three of the last five years.
- Scotland has a competitive export sector. Excluding oil and gas, Scottish exports to destinations outside the UK in 2011 totalled £23.9 billion. In the same year, a further £45.5 billion of goods and services were traded with the rest of the UK. These competitive strengths in high-value added sectors reflect Scotland's developing economy and a highly skilled workforce.
- Scottish international exports are well diversified across a wide number of sectors. Key strengths include the Food and Drink sector (18%), reflecting high demand overseas for Scottish Whisky.

Table 1d: International Exports by Sector⁷, Scotland, 2011⁸



⁷ Excludes Oil and Gas Extraction

⁸ Data Source for Statistics: Scottish Government: Global Connections Survey

Scotland's Strong Financial Foundations

The Scottish Government has published a document setting out "Scotland's Balance Sheet" (Annex A). The Balance Sheet takes no account of the different policies that an independent Scottish Government might pursue in order to boost growth and increase revenues. However, by looking at Scotland's current fiscal performance, it tells us what the starting point for an independent Scotland would be.

Firstly, it makes clear that Scotland's share of the UK national debt is lower as a percentage of GDP than the UK's. UK public sector net debt at the end of 2011-12 stood at £1.1 trillion (72% of GDP). Scotland's per capita share would have been equivalent to £92 billion (62% of GDP). If Scotland was assigned a share based on its historic fiscal position since 1980-81 it would be worth approximately £56 billion, equivalent to 38% of Scottish GDP.

However, it should be noted that Scotland could not reasonably be expected to take on a share of the UK's liabilities if Westminster insists Scotland is not entitled to a share of the assets.

The Balance Sheet also shows that as a proportion of GDP, both total public spending and spending on social protection, which includes spending on the welfare state and pensions, in Scotland is lower than for the UK -- indeed, it is lower than for most other EU-15 countries.

In terms of taxation, the Balance Sheet demonstrates that in every one of the last 30 years we have generated more tax per head than the UK.

Since 1980-81, total tax revenue per capita in Scotland has been on average £800 a year higher than in the UK as a whole. Adjusted for inflation, the gap has averaged £1,350 over this period.

Over the past five years Scotland and the UK have both run a fiscal deficit, as summarised in Table 2. This is not unusual. Between 1980 and current estimates for 2014, there will have been only one year when the 35 countries in the OECD as a whole have run an overall fiscal surplus. But over the past five years Scotland's deficit has been lower than for the UK as a whole.

Table 2 Net Fiscal Balance

Table 2: Net Fiscal Balance: Scotland and UK (2007-08 to 2011-12)					
(% GDP)	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	-2.9%	-2.6%	-10.7%	-8.1%	-5.0%
UK	-2.6%	-6.9%	-11.2%	-9.5%	-7.9%

Source: Government Expenditure and Revenue Scotland 2011/12

Section 2: Advantage Scotland

Scotland's Resources

Scotland is energy rich to an extraordinary degree.

There are estimated to be up to 24 billion barrels of oil to be extracted from the North Sea, although some industry experts believe this figure could be higher⁹.

Scotland is already one of the best places in the world to invest in renewable technology. We have 25% of Europe's off-shore wind and tidal resource and also 10% of Europe's wave resource.

We already generate more than one-third of our electricity needs from renewables. We are a world-leader in the fast growing green technology sector.

Scotland's Global Reputation

We have an international reputation for producing quality goods and services. Our food and drink sector has a turnover of more than £12 billion.

We have a tourism industry which employs almost 200,000 people and our country is famed across the world for its beauty and hospitality.

We are world-class at attracting inward investment and have a growing network of business ambassadors.

Scotland's Ingenuity

Scots have been among the greatest entrepreneurs and innovators the world has ever seen.

Scotland is home to a thriving cutting-edge life sciences sector.

Our innovators are responsible for pioneering the ATM, Dolly the Sheep, MRI scanning, penicillin, television and many other world-renowned inventions and discoveries.

We have a creative industries sector with a turnover of £4.8 billion¹⁰.

Our manufacturing sector exported £14.7 billion in 2011¹¹.

There are few other countries on earth with a better combination of those advantages, resources and talent.

⁹ <http://caledonianmercury.com/2013/05/09/39262/0039262>

¹⁰ Source: Scottish Government, ONS (Annual Business Survey)

¹¹ <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Q/pno/1>

A committed European nation

The current UK Prime Minister has said that, if his party forms the government after the next Westminster general election, he will hold an in-out referendum on the UK's membership of the EU.

The Scottish Government's position is that an independent Scotland should remain inside the EU. Being part of the EU single market – of 500 million consumers – is one of the factors that makes Scotland attractive to inward investment.

Following a Yes vote in the independence referendum, the Scottish Government will notify the EU that it intends to remain inside the EU as an independent member state.

Negotiations on the terms of that membership would then commence and take place in parallel with negotiations with the UK government, with a view to Scotland becoming independent in March 2016.¹²

With our resources, history in Europe and commitment to being a constructive partner in European affairs, no-one has seriously suggested that Scotland's continued membership would not be welcome. Graham Avery, senior member of St. Antony's College, Oxford University, and Honorary Director-General of the European Commission, has said: "For practical and political reasons, the idea of Scotland leaving the EU, and subsequently applying to join it, is not feasible." And he has added: "From the political point of view, Scotland has been in the EU for 40 years; and its people have acquired rights as European citizens."¹³

Professor James Crawford, who co-authored a paper for the UK Government on an independent Scotland's international status said the Scottish Government's 18 month timescale for concluding discussions with international organisations, such as the EU, was "realistic"¹⁴.

Education in our DNA

Independence offers Scotland an opportunity to fully mobilise its resources. We recognise that the skills and industries of today will not necessarily be the same as those of tomorrow. That is why we are already building the foundations of our future workforce through our world-class educational system. With full powers, we will be able to adapt and enhance our approach founded on:

- investment in early years. This is fundamental both for improving individual opportunity and building a stronger society and workforce;
- equipping our young people for the 21st century through the Curriculum for Excellence (CFE);

¹² <http://www.scotland.gov.uk/Publications/2013/02/8079>

¹³ <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmfaff/writev/643/m05.htm>

¹⁴ BBC Radio 4 "Today" programme. February 11 2013

- continuing to support our universities. We have more in the global premier league per head of population than any other nation. These universities are an important economic asset for Scotland, as they provide the highly-skilled graduate workforce needed for the future;
- ensuring that education continues to be free – a core Scottish value;
- continuing our investment in Higher Education Research and Development (HERD) which is at world class levels – the latest official statistics show that, in 2011¹⁵, Scotland’s HERD expenditure as a percentage of GDP ranked first compared to the other countries of the UK and in the top quartile of OECD countries;
- ensuring all post-16 learning is structured with a system-wide focus on jobs and growth which is more aligned with the demands of business; and
- delivering record numbers of modern apprenticeships and training places, while making an explicit commitment to Opportunities for All: offering a place in training or education for every 16 to 19 year old in Scotland who is not in work.

Our Growth Sectors

Our Economic Strategy identifies our growth business sectors. Below we set out the reasons for identifying them as such and highlight their current strengths and their potential for growth. With independence, these sectors could benefit in a number of ways, and this is explained in section 4.

Life Sciences

Scotland has a global reputation in life sciences. Discoveries such as Interferon, the P53 cancer suppressor gene and the cloning of Dolly the Sheep have given Scotland a strong international footprint and have had a major impact on modern healthcare. For example, the Jones Lang, Lasanne Life Sciences Cluster Report, Global 2011 says: “Edinburgh is a hotbed of life sciences innovation, with particular achievements in recent years in the field of stem cell research. The Queen’s Medical Research Institute brings together four world-class research centres specializing in Cardiovascular Science, Inflammation Research, Reproductive Biology and Regenerative Medicine.”

The Highland Diabetes Institute is also a unique model, pioneering cutting-edge research through a partnership between a:

- commercial company - LifeScan Scotland Ltd., Inverness is the home for the worldwide diabetes research and development into blood glucose monitoring carried out by the company;
- academic institution - University of Highlands and Islands Department of Diabetes & Cardiovascular Science; and,
- national health provider - NHS Highland Diabetes Centre.

¹⁵ Gross Expenditure on Research and Development Scotland; 2011

These organisations, working together, are at the forefront of diabetes expertise in promoting high standards of diabetes patient care, teaching, the pursuit of scientific and clinical research, and in the development of medical devices.

The individual partners operate independently within the Highland Diabetes Institute but by bringing them together under one roof they can benefit from collaborating with one another on topics of mutual interest.

The life science sector makes a significant contribution to the Scottish economy. In 2012 the sector provided employment for around 32,500 people in 650 companies and organisations¹⁶. Turnover in 2010 is estimated at around £2.9 billion, with gross value added (GVA) at around £1.5 billion¹⁷. Sub-sectors such as medical technology (medical devices and diagnostics) and pharmaceutical services have seen particularly strong growth over the past 10 years.

Our ambition to double the economic contribution of life sciences to the Scottish economy by 2020 is captured within the refreshed Scottish Life Sciences Strategy, “Creating Wealth, Promoting Health”.

Creative Industries

Scotland's creativity is recognised throughout the world and we have a strong international reputation for excellence. In 2010, the creative industries in Scotland had turnover of £4.8 billion and contributed £2.7 billion of GVA to the Scottish economy¹⁸. The sector employed 64,000 people in 2011, and exports represent around 5% of Scotland's total international exports¹⁹. Scottish art, film, fashion, music and literature are well recognised, as are Scotland's design, IT and computer gaming industries. Films, such as World War Z and Skyfall, take advantage of our landscape as a film location. The animated feature Brave was also set in Scotland's characteristic Highland landscape and formed the centre of a major tourism campaign.

Scotland has a wealth of museums and galleries presenting world class and diverse collections attracting visitors from around the world. The Scottish Government contributed over £15 million²⁰ to a £47 million transformation of the National Museum of Scotland, which, once opened has become the most visited attraction in Scotland²¹ (9th in UK) with just under 1.9m visitors in 2012. We are also being increasingly recognised as the home of festivals which not only act as a magnet for international visitors and performers but contributes significantly to our economy with Edinburgh Festivals generating tourism revenue worth £261 million in 2010²².

¹⁶ Source: Scottish Enterprise Source Book 2012

¹⁷ Source: ONS, 2010 Annual Business Survey

¹⁸ Source: Scottish Government, ONS (Annual Business Survey)

¹⁹ Source: Scottish Government, ONS (Business Register and Employment Survey (BRES))

²⁰ <http://www.scotland.gov.uk/Topics/ArtsCultureSport/arts/Key-projects/Capitalprojects>

²¹ <http://alva.org.uk/details.cfm?p=423> Association of Leading Visitor Attractions (ALVA) 2012 Visitor Figures

²² <http://www.festivalsedinburgh.com/sites/default/files/Edinburgh%20festivals%202010%20Impact%20Study%20Report.pdf> – Edinburgh Festivals Impact Study – BOP Consulting – May 2011.

Our vision for Scotland's creative industries is one which blends Scottish Government support with the industry's passion to contribute to sustainable economic growth. The sector has grown rapidly over the past 10 years, and with appropriate support has potential to grow further.

The Scottish Government, for example, has long championed tax incentives for Scotland's games industry – a global success story with close links to our universities.

Scotland's Digital and ICT Industry: A Networked Nation

The Scottish ICT sector currently employs around 47,000 people, and makes a direct contribution of £3.6 billion per annum to the Scottish economy.²³

Scotland has a strong digital and ICT foundation in areas such as:

- big data
- digital health and care
- smart mobility
- sensor systems.

Inward investment is attracted by the skills we can offer and the quality of the research taking place in our leading universities. It has been estimated that the IT and Telecoms sectors require 9,600 new entrants each year over the next few years, making them one of the most vibrant sectors of the economy.

Our vision is to ensure that by 2020, Scotland enjoys a world-class, future proofed digital infrastructure²⁴

An independent Scotland would have the opportunity to use new regulatory powers to ensure that we meet the connectivity needs of both our rural and urban areas, by setting coverage obligations for providers that reflect the unique demands of our population.

We also need to ensure that our commitment to developing connectivity is matched by action to promote digital participation, stimulate the digital economy and deliver high quality digital public services. Everyone -- individuals and businesses -- should have the confidence, capability and skills to make best use of digital technologies and to take full advantage of the benefits a digital economy can bring.

We are on the cusp of a new digital revolution which will transform economies around the world. We want Scotland to be at the forefront of that revolution and to have cemented its place as a world-class digital nation by 2020.

²³ <http://www.scotland.gov.uk/Topics/Statistics/Browse/Business/SABS/Sectors>

²⁴ <http://www.scotland.gov.uk/Resource/Doc/981/0114237.pdf>

North Sea Oil and Gas – “a fertile landscape for investors for many years to come.”

In 2011, oil and gas production contributed £26 billion to Scottish GDP.

The sector is also a major exporter, with exports of oil, gas and petroleum products boosting the UK balance of payments by an estimated £40 billion in 2011²⁵.

Analysis by Professor Alex Kemp of Aberdeen University estimates that, when Scotland’s share of the UK Continental Shelf (UKCS) is demarked using the median line, it accounted for 96% of UK offshore oil production and 52% of offshore gas production in 2011. This resulted in Scotland accounting for an estimated 78% of total UK hydrocarbon production in 2011²⁶.

Scotland’s estimated geographical share of UK offshore tax revenue is larger due to the prevalence of oil production in the Northern North Sea which is relatively more profitable. Scotland’s geographical share of oil and gas production is estimated to have generated £10.6 billion in tax revenue during 2011-12, 94% of the UK total.

Recently there has been a large increase in investment in the North Sea, reflecting the industry’s confidence that there are many more years of revenue to come. Between 2011 and 2012, total North Sea oil and gas investment increased from £8.5 billion to over £11 billion, the highest level for 30 years. An even higher level of investment of over £13 billion has been forecast in 2013.²⁷

In fact, companies are thought to be planning to invest an extra £100 billion in future years.

The latest oil and gas licensing round has been described as a “bonanza” by the UK Government, which says the North Sea will remain a fertile landscape for investors for many years to come²⁸.

Some estimates say reserves could now be in excess of 24 billion barrels. Previous analysis by the Scottish Government suggested remaining reserves could have a wholesale value of £1.5 trillion. Indeed, on an internationally comparable basis, Scotland is estimated to have the largest reserves of oil in the EU, accounting for 60% of the EU total²⁹.

²⁵ DECC (2012) – Digest of United Kingdom Energy Statistics 2012. Table G.2

²⁶ <http://www.scotland.gov.uk/Resource/0041/00416072.pdf>

²⁷ Oil and Gas UK 2013 Activity Survey

²⁸ <http://www.govtoday.co.uk/research-news/13401-north-sea-oil-and-gas-licensing-round-bonanza>

²⁹ For future analysis of Scotland’s oil and gas reserves see the Scottish Government Oil and Gas Analytical Bulletin

So the question for Scotland is not whether oil and gas will continue to generate significant economic benefits for many years to come - it is whether we will have the power to steward these resources for our current and future generations.

An oil stabilisation fund

As an independent country, Norway has been able to use its oil wealth to establish an oil fund, now worth close to £450 billion, equivalent to approximately £90,000 per person. Our vision is of a Scotland that has the freedom to make the decision on how our oil wealth is distributed in a way that reflects our country's needs. There is still an opportunity to set up a fund to take advantage of the tax revenue that will accrue from the 24 billion barrels of oil that could still be extracted from Scottish waters.

The independent Fiscal Commission Working Group has set out a number of recommendations and proposals including in relation to a Scottish oil fund:

“In principle, the Working Group sees clear merit in investing at least a proportion of the receipts from North Sea revenues into an Oil Fund to invest for future generations. This would ensure that a share of the wealth generated from oil production is transferred to a separate fiscal account where it can be saved and invested over the long-term. This is the approach which has been adopted in Norway.

“Adopting this strategy historically would have allowed the Scottish Government to establish a significant asset base. For example, if the Scottish Government had the opportunity to invest the net fiscal surpluses achieved since 1980 it could have accumulated assets equivalent to between 62% and 84% of GDP.”

The Working Group recommended that The Scottish Government should seek, in principle, to establish a stabilisation fund to help manage its natural resources and to enhance future economic resilience.

In the short-run, such a mechanism could be established even if there is borrowing. The fund could be used to smooth expenditure and borrowing during economic shocks. The Fiscal Commission Working Group recommended that:

“An attractive approach in the short-term would be to plan the government's spending plans on the basis of a cautious forecast of oil revenues produced by an independent fiscal commission. Then, if oil revenues exceed the forecasts, the excess could be transferred into a stabilisation fund.”

Drawing on Scotland's financial strengths relative to the UK, such an approach would offer a credible way to ensure predictability in the budget process and in the setting of policies and spending programmes.

Scotland's Renewable Resources: a powerhouse of Europe

In July 2012, the UK Department for Energy and Climate Change (DECC) published figures on renewables investment and jobs, which showed there were £2.3bn of renewables projects announced in Scotland between April 2011 and July 2012, with an associated 4,600 jobs.

Scotland is already one of the best places in the world to invest in renewable technology. We have 25% of Europe's off-shore wind and tidal resource and also 10% of Europe's wave resource.

We have greater energy security than the UK (in terms of spare generation capacity) and we will help the UK to meet its legally binding renewable energy target.

In October 2012 Ofgem estimated the UK's capacity margin will reduce to 4% by 2015/16³⁰. Without the excess generating capacity from Scotland the Scottish Government estimates it would be at zero. An updated estimate is due from Ofgem in June which is expected to show a further tightening of capacity margins due to recent fossil fuel plant closure announcements by generating companies.

In contrast the Scottish Government estimates that Scotland's hypothetical capacity margin will be 25% by 2015/16. Ofgem continue to highlight the challenge that the UK faces in keeping the lights on, and Scotland's generation capacity is a key part of meeting that challenge, especially since our European neighbours face similar capacity issues, meaning the UK cannot therefore rely on capacity from outside the UK system.

Europe's Energy Commissioner, Günther Oettinger, said in a recent speech in Aberdeen: "In the last 50 years, North Sea oil and gas have powered growth in the UK and beyond. In the future, wind, wave, and tidal energy could make Scotland a power house of Europe³¹."

"Scottish energy means trade for Scotland. Electricity from here goes via England to the Continent. And with the European North Sea Offshore Wind Grid, Scotland could be linked into a Europe-wide network."

We are already working hard to fully exploit this huge potential. We have launched the Grand Challenge phase of the Saltire Prize – the largest marine energy challenge prize in the world.

At this time, there are more wave and tidal power devices being tested in the waters off Scotland than in any other country in the world.

Importantly, the skills and expertise which have made the North Sea Oil and Gas industry such a world-class success can be harnessed to drive the renewable sector.

³⁰ <http://www.ofgem.gov.uk/Markets/WhlMkts/monitoring-energy-security/elec-capacity-assessment/Pages/index.aspx>

³¹ Commissioner Oettinger's Speech at the Scottish Energy Institute dinner: Aberdeen: 28 February 2013

We have knowledge of engineering in hostile, deep-water environments which has few rivals anywhere in the world.

We are now starting to see the benefits and fruits of collaboration between the industries. An increasing number of oil and gas companies, such as Subsea 7, Technip and the Wood Group, are entering the offshore wind market. The Scottish Government is confident that the knowledge and expertise from oil and gas will be a huge competitive advantage to the marine industry of renewable technologies.

SCOTLAND'S LOW CARBON ECONOMY

In 2007-08, Scotland's low carbon market was worth around £8.5 billion (8.5% of our economy) and is forecast to rise to around £12 billion by 2015-16;

Low carbon sector jobs could grow by 4% a year to 2020, rising from 70,000 to 130,000, over 5% of the workforce;

Offshore wind alone could bring in around £30 billion of inward investment, and up to 28,000 jobs; and,

Sales of off-shore electricity could value £14 billion by 2050; equating to £2,700 for each person in Scotland.

Source: The Government Economic Strategy: 2011

An independent Scotland can ensure that all of Scotland benefits from maximising the potential that our renewable landscape has to offer.

A low carbon economy

Present conditions, while challenging, offer enormous hope for achieving a low carbon economy. To clarify the future path of our economy, the Scottish Government has committed to four transformational changes:

- decarbonise electricity generation by 2030 and largely decarbonise the heat sector by 2050;
- almost completely decarbonise road transport by 2050;
- significant decarbonisation of rail by 2050; and
- establish a comprehensive approach to ensure that carbon is fully factored into strategic and local decisions about rural and urban land use.

The Scottish Government has set itself stretching interim targets:

- the equivalent of 100% of Scotland's demand for electricity to be met by renewables by 2020;
- end use energy consumption to reduce by 12% by 2020; and

- 11% of heat demand to be met by renewables by 2020.

The transition to a low carbon economy will help us become more resilient and support economic recovery and provide us with a platform for greater international trade. Taking the opportunity now means lowering costs in the future: both in terms of future costs of carbon and lost growth opportunities as other countries embrace low carbon objectives. Taking early advantage of low carbon opportunities will support future growth by creating opportunities for Scotland's businesses to export their products and expertise to other nations.

Food and Drink: World-class quality

Scotland is a land of food and drink. We have some of the best natural produce in the world. The food and drink we rear, grow and make stands for quality, for beautiful unspoilt landscapes, clear air, pure water and all the traditions of good husbandry. People around the world attach these values to food and drink from Scotland. They know that our Scotch beef and lamb, our excellent seafood, such as langoustines, scallops and salmon, our staple crops, and our soft fruit are second to none.

That is why this sector is an outstanding success and a key contributor to the Scottish Government's ambition to increase Scottish exports by 50% by 2017. The facts speak for themselves:

- Food and Drink³² exports have grown 50% since 2007, reaching £5.38bn in 2011, and making it one of the biggest export sectors.
- Turnover in the food and drink growth sector³³ has been estimated at £12.4bn for 2010.
- Between 2007 and 2012, retail sales of Scottish food and drink brands across Great Britain have increased by 28%.
- Scotland is the world's third largest salmon producer³⁴.
- We land 60% of the UK's fish³⁵.
- We have more than one quarter of the UK's beef herd³⁶.
- 40 bottles of whisky are reported to be shipped overseas each second³⁷.

Food and drink manufacturing comprises around 835 businesses³⁸, including strong indigenous players with key brands, global players with significant inward investment and many smaller firms with a strong heritage, innovative products and the potential to grow. Our strength lies in a diverse company base across a wide product range.

³² 'Drink' is defined as exports of Scotch Whisky from the UK

³³ Comprised food & drink manufacturing, sea fishing & aquaculture plus agriculture

³⁴ Food and Agriculture Organisation (United Nations)

³⁵ Source: Scottish Govt Sea Fisheries Stats

³⁶ Source: Scottish Agricultural Census

³⁷ Scotch Whisky Association

³⁸ Scottish Annual Business Statistics 2010

Manufacturing Success

From luxury fabrics through to innovative engineering, Scottish manufacturing companies excel in quality. The manufacturing sector had total international exports of £14.7 billion in 2011, accounting for 61 per cent of Scotland's total international exports.³⁹ The manufacturing sector's international exports in 2011 were up by £1.1 billion from the previous year⁴⁰.

The Scottish Government firmly believes that science and engineering are key to creating a more successful Scotland. To lever this potential, we need a workforce with the skills and capabilities required to meet the existing demands of the industry and the innovative creative talent to shape new markets in our economy.

Manufacturing needs continual investment at a high level to ensure that the pipeline of new discoveries and products continues. To achieve this requires improving routes to sources of private and public investment. Scotland is strongly committed to using public finance alongside much-needed private investment. Scotland already has a strong business angel investment community, coupled with the Scottish Investment Bank (SIB), which currently supports the sector.

With the full powers of an independent nation, we could increase our competitive advantage by ensuring Scottish manufacturing is better 'tuned' to domestic and international demand. Access to a full array of economic levers would place us in a much better position to take advantage of growth, export and job creation opportunities.

Given the importance of manufacturing for exports, innovation and the quality of its workforce, governments in an independent Scotland would be able to decide whether to use the tax system and other economic levers to boost incentives for growth companies and to encourage innovation.

Financial and Business Services

The financial and business services industry is one of the growth sectors identified as providing an opportunity to strengthen Scotland's areas of international comparative advantage which has the capacity to boost productivity.

Scotland is internationally recognised as the most important UK financial centre outside London and the South East, with a breadth of services including global custody, asset servicing, banking, investment management, corporate finance, general/life assurance and pensions.

Scotland remains an attractive and highly competitive location for both indigenous and international businesses, and recent announcements of expansion and investment plans by financial services companies have buoyed prospects for the future.

³⁹ <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Q/pno/1>

⁴⁰ Global Connections Survey 2011

The Scottish Government, the wider public sector and the financial services industry itself continue to show commitment to work in partnership through the unique collaboration of the Financial Services Advisory Board (FiSAB) to ensure that Scotland is recognised as a successful international financial services centre.

The recently published Scottish Government banking strategy, “Sustainable, Responsible Banking: A Strategy for Scotland”⁴¹, sets out what the Scottish Government considers to be the key principles of a healthy, diverse and competitive banking sector in Scotland. It outlines a range of measures that can be taken in the current environment to encourage diversity in the sector and to restore traditional Scottish banking principles of professionalism, stewardship and prudence.

Our aim for financial regulation in an independent Scotland is for:

- a thriving financial service sector as part of a balanced economy. Scotland’s financial services will be the gold standard; and,
- the right services available to all of Scotland’s people. This will go beyond big high street banks, and include credit unions and, potentially, new forms of finance, and pensions.

Independence opens the opportunity for Scotland to create a successful financial sector that meets the needs of consumers and businesses. This will make a significant contribution to Scotland’s sustainable economic growth and assist in tackling inequality and boosting prosperity.

We want to develop a diverse, competitive financial services industry that is responsive to the needs of its customers, that understands its wider role in society and that behaves accordingly. A properly regulated and functioning financial system can play a key part in delivering this ambition.

Recent events in the global economy show this can only be achieved when effective use of regulation and supervision is combined with a positive culture focused on responsibility, stability and the wider economy. This approach is fundamental if we are to return to a banking system based on stewardship, prudence and probity.

Tourism – welcoming the world

Scotland’s beauty, magnificent attractions and hospitality are famed across the world. Tourism is one of Scotland’s most important sectors, directly contributing £2.9 billion GVA⁴² annually to the economy. It employs almost 200,000 people in almost 14,000 diverse businesses, accounting for around 8% of employment in Scotland⁴³.

2014 is due to be one of the biggest years in Scottish tourism’s history as we prepare to welcome the world to visit Scotland for the Commonwealth Games, the

⁴¹ Sustainable, Responsible Banking: A Strategy for Scotland (May, 2013)

⁴² Source: Scottish Government Growth Sector Database (January 2013)

⁴³ Source: Scottish Government Growth Sector Database (January 2013)

Ryder Cup and Homecoming Scotland. Staging these major events in Scotland leaves no doubt of the firm foundations we have to build upon.

Overseas tourism contributes significantly to our earnings; therefore boosting tourism would make a positive contribution towards meeting our export target.

Scottish tourism has faced a challenging time through the recent economic recession, but remains resilient. The latest performance figures are:

Overnight visitors spent £4.29 billion in Scotland in 2012. Of this figure, the British market is worth £2.89 billion. 15 % of visitors are from overseas, spending £1.4 billion.

The value of 'daycations', day tourism trips without an overnight stay, measured in 2011 by VisitScotland is estimated to be £4.6 billion⁴⁴.

The Scottish Government is committed to creating an environment in which businesses have an opportunity to flourish, underpinned by a fair and efficient taxation system.

The UK Government's Air Passenger Duty (APD) is making Scottish airports uncompetitive in their efforts to attract new direct international routes and adds significantly to the cost of flying to and from Scotland. UK APD is the most expensive aviation duty in Europe, and the UK is ranked second lowest in the world in terms of competitiveness of ticket taxes and airport charges. A tax regime of this kind may be justifiable in terms of seeking to reduce pressure on overcrowded airports in South-East England. It is difficult to justify with regard to Scotland's circumstances – an example of UK fiscal policies not being appropriate to Scotland.

In an independent Scotland, a competitive Scottish aviation taxation regime could stimulate new and existing direct international services, important for business connectivity, by reducing disincentives to fly to Scotland. There is strong support across the industry for the devolution of APD, including from our 4 largest airports.

An independent Scotland could also choose to follow the example of many EU countries by adjusting the VAT rate to help tourism. The UK imposes one of the highest rates of VAT in Europe. 23 of the 27 EU countries currently offer some form of reduced VAT rate to their hospitality sectors. With the ability to adjust VAT rates, we could choose to follow suit.

⁴⁴ Great Britain Day Visitor Survey 2012

Section 3: Westminster Isn't Working for Scotland's Economy

Section 2 has set out the advantages and strengths of the Scottish economy. It has also set out the work the Scottish Government is doing to create a competitive business environment.

Successive administrations in Scotland have taken forward economic policies that they believe were in the best interests of Scotland.

Since devolution our economic performance has improved because of our ability to use even limited levers in the interests of Scotland. For example, at the height of the financial crisis, the Scottish Government was able to mobilise the resources of the public sector in Scotland to implement a distinctive Economic Recovery Plan. This helped contribute to Scotland experiencing a shallower recession than the UK as a whole.

There are also numerous examples in particular areas of economic development – such as in our renewables ambitions – where a distinct approach in Scotland has provided real economic benefits.

However, the paradox we face is that despite all of these strengths, we are not as successful as we should be. The one-size fits all policies implemented by the Westminster based UK Government are not generating the growth or delivering the social cohesion that Scotland should be enjoying.

The evidence for the proposition that Westminster isn't working for Scotland lies in current Westminster policy, in our long-term economic performance relative to other small nations, in the growing gap between rich and poor, and in a system which has clearly benefitted London and the South-East to what is now a quite startling degree.

Current Westminster economic policy

It is clear that current UK Government economic policy is letting Scotland down. Despite repeated warnings of the dangers of an austerity programme that was too fast and too deep, the UK Government continues to press ahead with plans to cut spending for an unprecedented eight consecutive years.

The Scottish Government has long argued that the best way to reduce the deficit is to return the economy to growth. In contrast, the UK Government's actions have stalled the recovery with output now currently below its pre-crisis peak and no higher than it was in Q3 2008. Moreover, the very motivation of the deficit reduction policy to tackle the legacy of debt inherited from the previous UK Government has back-fired with borrowing higher than forecast, the loss of the UK's AAA status and the Chancellor being forced to abandon one of his 'fiscal rules'.

Capital Investment is crucial to sustainable economic growth and is central to the Government's Economic Strategy. Improving our physical infrastructure brings immediate benefits to our economy by supporting our construction sector and its supply chain.

When the financial crash took place, the Scottish Government was quick to recognise that capital spending would be a key driver, both of the recovery and of long-term growth.

However, the response to the recession of the last five years has been a case in point of the difference the powers of independence can make to the lives of ordinary people.

Both the former Labour government and the current Coalition government took the decision that capital spending would take a disproportionate share of the cuts. The Coalition has largely followed the Labour blueprint on capital spending since it came to office.

The Scottish Government took a very different view. We saw capital spending on infrastructure as vital to supporting the economy and an important engine of economic growth. We took action to support capital investment.

The Scottish Government brought forward capital investment from future years to support investment in the present. We took action to transfer revenue to capital spend and we instituted the NPD scheme to generate more capital investment.

While these actions were worth undertaking, they all have limitations. The capital spend that was brought forward was constrained by the UK and had to be deducted from the next year. The transfer from revenue to capital was taking place in the context of real terms cuts to revenue spend and was therefore also limited in scope; and the NPD scheme is inevitably slower to mobilise and costlier than traditional capital investment.

What was really needed, as the Scottish Government consistently argued, was to increase direct public spending on infrastructure rather than dramatically cut it - the policy of Labour and the Coalition.

Table 3 sets out the position with regard to the Scottish Government capital budget since 2009-10 and what the figure would have been if the budget had been maintained at 2009-10 levels in real terms.

Table 3						
£ Millions	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015
Scottish Capital DEL	3,930	3,293	2,762	2,676	2,508	2,659
Capital DEL if spending maintained at real 09-10 levels	3,930	4,037	4,120	4,174	4,270	4,351
Difference	0	-744	-1,358	-1,498	-1,762	-1,692

As shown in Table 3, had the 2009-10 levels of capital spending been maintained, this would have produced cumulative increased investment of £7 billion in the five years to 2014-15. This corresponds to approximately £1.4 billion a year.

Additional capital investment of such magnitude would have supported an additional 19,000 jobs over the subsequent five years. And, as Scotland's Balance Sheet demonstrates, this increased level of investment could have been achieved in the context of Scotland's £12.6 billion relatively stronger fiscal position vis-a-vis the UK in the five years to 2011-12.

The long-term growth gap

Given the advantages, resources and talent we enjoy, it is useful to compare our economic performance with both the UK and other comparable countries.

Work carried out by the Fiscal Commission Working Group concluded:

“It is widely accepted that, in terms of economic growth, Scotland has underperformed relative to both the UK and other small EU countries.”

Table 4 demonstrates this underperformance. The 0.5 percentage point gap with the UK and the 0.4 percentage point gap with other small EU countries over the 30 years to 2007 is a clear failure in the Westminster Government's role to encourage growth in all parts of the UK, not just London.

It is the view of the Scottish Government that this growth gap is due to the fact that, in a competitive globalised economy, targeted policies designed to capture the unique strengths and address the relative weaknesses of an economy are vital. The current constitution arrangements do not allow economic policies to be tailored to the challenges faced in Scotland. This puts Scotland at a disadvantage and is also evident in the divergence in performance of the economies of other regions within the UK in relation to London and the South East.

Table 4: Average Annual GDP Growth Rates					
	Average Annual GDP Growth			Gap (Scotland minus UK/Small EU)	
	Scotland	UK	Small EU	UK	Small EU
1977-2007⁴⁵	2.3%	2.8%	2.8%	-0.5%	-0.4%
1998-2007	2.9%	3.1%	3.1%	-0.3%	-0.2%
1998-2011	1.8%	2.0%	2.1%	-0.2%	-0.3%

Source: Scottish Government, ONS, OECD (Note differences may be due to rounding)

⁴⁵ Data for illustrative purposes only. Scottish data prior to 1998 are estimated by applying a UK SIC 07 to SIC 03 ratio to historic Scottish GVA figures

The UK government also reported the startling fact that the size of Scotland's economy is now half that of Norway's, even though both countries have similar populations and both are oil rich.
<https://www.gov.uk/government/publications/scotland-analysis-currency-and-monetary-policy> (page 15).

Income inequality

The UK is the fourth most unequal country in the developed world. As well as limiting the potential and prosperity of individuals, such inequality is bad for our economic health.⁴⁶

The Fiscal Commission Working Group pointed to the negative impact of growing inequality on the Scottish economy and recommended that the Scottish Government should explore and prioritise opportunities to address inequalities in an independent Scotland.

The Group's report said:

"Scotland is currently part of a UK economic model and society which is one of the most unequal in the OECD. Inequality within the UK has increased in recent decades. Such patterns of inequality will continue to have a negative impact on growth and prosperity over the long-term.

"However, the vast majority of the important policy levers that can tackle these issues are reserved to the UK Government. Independence would provide the opportunity for tailoring Scottish policy responses to Scottish economic conditions. It would be the responsibility of the Scottish Government to ensure whether these policies are used optimally or not."

The report went on:

"A number of economists have argued that inequality can have adverse impacts on both economic performance and social well-being. For example, in his analysis on the links between inequality and growth, Professor Joseph Stiglitz concludes that countries which are more unequal do not do as well, do not grow as well and are less stable."

And it said:

"Without access to the relevant policy levers – particularly taxation and welfare policies – there is little that the Scottish Government can do to address these trends."

The impact of inequality on economic growth has been examined in detail by Professor Stiglitz. In his latest book: "The Price of Inequality," he deals with the economic and social challenges that come with increasing inequality. In particular he identifies how the change in consumption patterns associated with an increasingly unequal income distribution can impact on growth.

⁴⁶ <http://bellwether.metapress.com/content/m10m3736514222q5/fulltext.pdf>

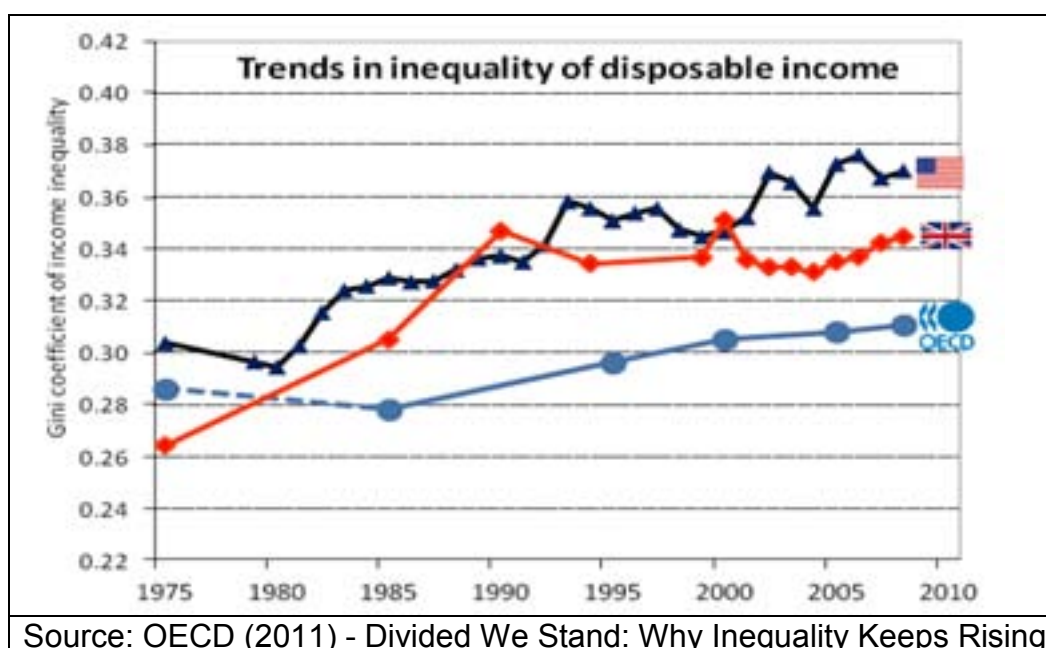
Professor Stiglitz identifies a link in the United States between the periods when the broadest section of American society have experienced higher net incomes and the periods when the US economy has grown the fastest.

His explanation for this is that, as an individual's income rises, the amount they spend as a proportion of their income on average declines. As a result, at an aggregate level, a highly skewed income distribution is likely to lower consumption relative to what it would be if the income distribution was more equal.

The link between inequality and social mobility – the ability of people from lower income backgrounds to move up in the world - has also been researched extensively.

A discussion paper, prepared for the UK Department for Business, Innovation and Skills, which reviews the literature on the subject, says that when using “intergenerational income elasticity” (i.e. the extent to which parents' income predicts their children's income) then high income inequality countries invariably experience lower social mobility.

The authors say it is likely to be very hard to increase social mobility without tackling inequality.⁴⁷



Despite continued economic growth and improving labour market conditions, there has been persistent growth in income inequality over the past 35 years. Research published by the OECD in 2011 found that since 1975 income inequality among working-age people, based on estimated Gini coefficients, increased faster in the UK than in any other OECD country⁴⁸. This is shown in the chart above, where a lower

⁴⁷ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32111/11-750-social-mobility-literature-review.pdf

⁴⁸ OECD (2011) – Divided We Stand: Why Inequality Keeps Rising <http://www.oecd.org/els/soc/49170234.pdf>

figure indicates a greater equality.

The trend of increasing inequality throughout the UK is also reflected in recent research from the ONS, which showed that, over the past 25 years, average earnings amongst the lowest paid 10% of the economy grew by 47% in real terms compared to growth of 81% amongst the highest paid 10%, and growth of 117% among the richest 1%.⁴⁹ Inequality is estimated to be slightly lower in Scotland, but is still too high.

As will be discussed later in this document, research suggests the issue of inequality and mobility seems to be particularly important for successful countries of Scotland's size.

Who benefits from Westminster? The dominance of London

A recurring theme of academics and UK government ministers in discussing economic performance has been a concern at persistent geographical inequalities in terms of income, jobs and output growth within the UK.

In particular, the dominance of London, and the reasons for this dominance, have been the focus of research. Such has been the scale of regional divergence within the UK that some academics have even questioned whether it is reasonable to use the "national" UK economy as a unit of analysis. They argue "the British are not all in the same boat but, increasingly, they are locked into different compartments."⁵⁰

A report from the Centre for Geographical Economic Research at the University of Cambridge says the "spatial imbalance" has become "an entrenched and enduring feature of the United Kingdom economy."⁵¹

The current UK government has also been interested in these geographical inequalities. In an economics paper published in 2010, the Department for Business, Innovation and Skills referred to research which showed economic divergence was growing faster in the UK compared with other comparable countries:

"The data for the most recent period (1995–2007) suggests that of the five industrial countries considered, Germany and Italy experienced a decrease in regional imbalances, France experienced neither increasing nor decreasing imbalances, while the United Kingdom and the United States experienced increasing imbalances."⁵²

⁴⁹ ONS (2012) – "Real wages up 62% on average over the past 25 years"
http://www.ons.gov.uk/ons/dcp171776_286266.pdf

⁵⁰ Ismail Erturk et al. "Accounting for national success and failure: rethinking the UK case." Accounting Forum(2012) .

⁵¹ <http://www.landecon.cam.ac.uk/staff/publications/ptyler/CGERworkingpaperno1v5.pdf>

⁵² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32113/10-1226-understanding-local-growth.pdf

The report went on:

“According to Barro and Sala-i-Martin (2001), the UK was experiencing the fastest rate of convergence; it now seems to be experiencing the fastest rate of divergence.”

This trend has been highlighted by senior UK Government ministers. David Cameron in his first major speech as Prime Minister said:

“Today our economy is heavily reliant on just a few industries and a few regions – particularly London and the South East. This really matters. An economy with such a narrow foundation for growth is fundamentally unstable and wasteful – because we are not making use of the talent out there in all parts of our United Kingdom.”

He added:

“Our economy has become more and more unbalanced, with our fortunes hitched to a few industries in one corner of the country, while we let other sectors like manufacturing slide.”⁵³

His deputy, Nick Clegg, has echoed this concern, arguing:

“For years, our prosperity has been pinned on financial wizardry in London’s Square Mile, with other sectors and other regions left behind. This imbalance left us hugely exposed when the banking crisis hit.”

To date, the evidence from official statistics indicates that there is little sign of the rebalancing that the UK Government suggests is required. In March 2013, the Office for National Statistics said:

“Looking at data between 2007 (before the economic downturn) and the latest available, a clear trend is apparent with London outperforming the rest of the UK economy.”⁵⁴

It found that between September 2007 and September 2012, workforce jobs increased by 267,000 in London but fell by 284,000 in the rest of the UK.⁵⁵

In addition, it is likely that the impact of the UK Government’s welfare reforms will make this divergence worse. Scottish Government analysis published earlier this year estimates that the UK Government’s welfare reforms could potentially reduce welfare expenditure in Scotland by up to £4.5 billion in the five years to 2014-15.⁵⁶ A report from Sheffield Hallam University found that, when fully implemented, the welfare reforms will take more than £1.6 billion a year out of the Scottish economy⁵⁷.

The following chart looks at the difference between the best and worst performing regions (which are equivalent to the NUTS 3 statistical regions) in a selection of OECD countries. The UK figure is distorted by the disproportionately high GDP per capita figure for the inner London West region. When this is stripped out the UK figure is still higher than most other countries included in the comparison.

⁵³ http://www.conservatives.com/News/Speeches/2010/05/David_Cameron_Transforming_the_British_economy.aspx

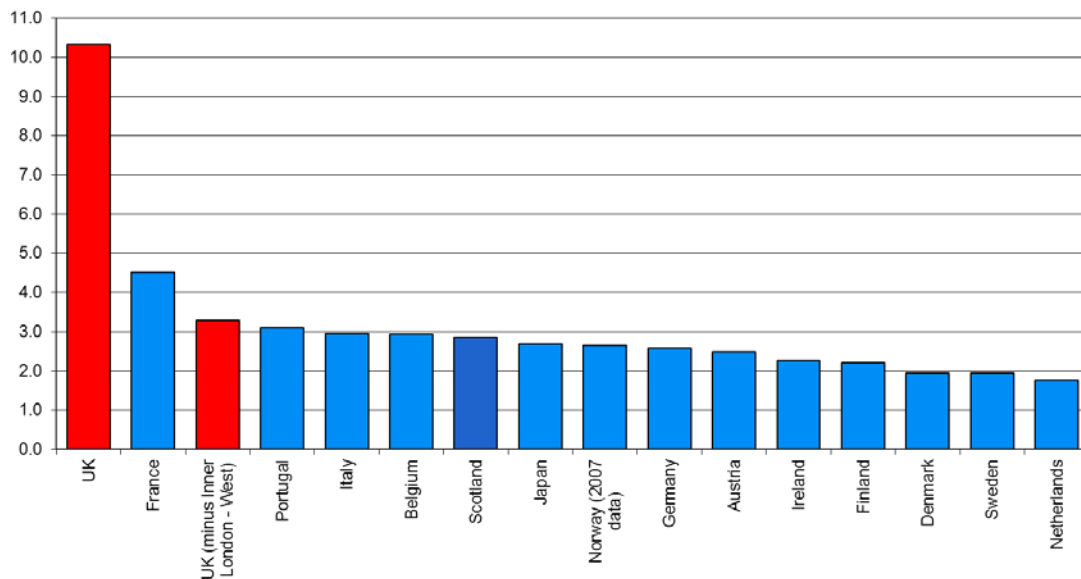
⁵⁴ http://www.thenorthernecho.co.uk/features/leader/8244486.Fair_shares/

⁵⁵ <http://www.ons.gov.uk/ons/rel/regional-trends/regional-economic-indicators/march-2013/sty---infographic-summary.html>

⁵⁶ <http://www.scotland.gov.uk/Resource/0041/00417011.pdf>

⁵⁷ http://shu.ac.uk/research/cresr/sites/shu.ac.uk/files/hitting-poorest-places-hardest_0.pdf

Gap in GDP per Capita across Regions (Highest divided by Lowest), 2009



Source:OECD, ONS

These trends pose some important questions for future jobs, business and economic growth prospects in Scotland:

- The Scottish Government’s Economic Strategy has a goal of “ensuring shared and sustainable economic growth that provides the most disadvantaged areas and people in society with the opportunity to prosper. We must maximise the potential of Scotland’s people, places, and assets”. Does being part of a system that demonstrates persistent inequality help or hinder that aim?
- Given the extent of economic divergence in the UK, does a one-size-fits all fiscal, employment, regulation and competition policy make sense?
- Does it make sense to be part of a system that is concentrating so much wealth in London?
- Are there any signs that the re-balancing, which the UK Prime Minister says is necessary to create a sustainable and stable economy, is happening or are these patterns now entrenched?

Can we rely on a Westminster Government with limited Scottish representation – and wider UK interests – to reflect and act upon the distinct needs and priorities of the Scottish economy?

Further trends have also become apparent, within the current system, which would appear to be harmful to growth:

- We know that women in particular have suffered from the recession, despite Scotland’s relatively strong recent employment performance.

- In order to help women into the workforce the Scottish Government's Council of Economic Advisers has been asked to produce an analysis of the impact on Scotland of moving to levels of childcare support seen across other European countries.
- Work carried out by The Resolution Foundation found that even in times of growth, across the UK, after accounting for inflation, median wages were essentially the same in 2008 as they were in 2003.

We know, too, that we need to promote greater entrepreneurialism in Scotland, encouraging more business start-ups and more high-growth domestically-owned companies, and we need to encourage greater innovation.

So, based on an analysis of Scotland's relative economic performance and the income and geographic inequalities of the UK, it is reasonable to conclude that Westminster isn't working and that the ability to tailor economic policy to suit Scotland's needs is urgently required.

Section 4: Independence - Scotland's Future In Scotland's Hands

Our ambition is for an economy that is diverse and grows sustainably, with high value jobs that pay decent wages, leading to greater equality of income and wealth and a higher degree of social cohesion.

This paper is not intended to be a policy manifesto, but it does set out the evidence that small economies perform well and that independence, within a continuing currency union, would give future Scottish governments the powers to address the imbalances and inequalities that inhibit economic growth. Moreover, we could build on the social democratic principles that the current Scottish Government has pursued in office to create a stronger, more diverse economy and a fairer society for the future.

A. Why countries of Scotland's size can and do succeed – when they are independent

The UK government says:

“Economic size is not, in and of itself, an important driver of an economy's success.”⁵⁸

However, there is interesting evidence that shows small countries (defined as having populations of less than 20 million) have been particularly successful in recent decades.

⁵⁸ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191786/Scotland_Analysis_acc-1.pdf

The economic development specialist, Dr David Skilling, noted last year that:

“These small countries currently make up 11 of the top 15 advanced economies by per capita income, 4 of the top 5 positions in the World Economic Forum’s global competitiveness ranking, and 14 of the top 20 positions in the UN’s Human Development Index.”⁵⁹

Dr Skilling has suggested a number of reasons these countries have succeeded.

Although there are different models for success, he says they “tend to adopt a more deliberate policy approach that is focused on competing in the global economy.”

They also understand, he says, “that their economies need to be distinctive in some way.”

It seems vital, therefore, to have the means to exploit country specific areas of comparative advantage.

In addition, there are some characteristics which successful northern European countries seem to share.

They have a strong external focus and are active globalisers.

They have relatively high levels of trust and have lower income inequality.

They have effective government.

There is a strong emphasis on innovation and technology.

In this respect, it is interesting to note that the UK economic policy-makers have been criticised for, among other things, creating an economy which fails to invest sufficiently in research and development, which has high levels of inequality and which runs large trade imbalances.

Perhaps more fundamentally, the policy framework for an economy of the size of the UK is simply inappropriate for a country of Scotland’s population.

To be more successful, Scotland needs to pursue key objectives (as set out in the Scottish Government’s Economic Strategy).

For example, the strategy recognises the need to promote Scottish exports, with an ambitious target to deliver a 50% increase in exports by 2017.

It discusses how to strengthen innovation and commercialisation.

It sets out how the Scottish Investment Bank provides both early stage and established businesses, with growth export potential, with better access to finance

⁵⁹ http://www.davidhumeinstitute.com/images/stories/Spring_2013/Small-countries.pdf

And it recognises the vital importance of infrastructure investment.

But the Scottish Government believes that these objectives – vital for economic growth and job creation – are becoming harder to meet because too many of the powers needed to achieve them are retained by a Westminster system that isn't working for Scotland.

B. Limitations of Current and Scotland Act Powers

Our purpose as set out by the First Minister in the Government Economic Strategy is to create a Scotland that is;

“...a more successful country with opportunities for all of Scotland to flourish through increasing sustainable economic growth.”

The current constitutional settlement limits the Scottish Government's ability to deliver on this vision for the people of Scotland and the Scotland Act 2012 fails to go far enough to address it.

The vast majority of key economic levers are reserved to the UK Government.

For example, the Scottish Government is committed to creating an environment in which businesses have an opportunity to flourish, underpinned by a fair and efficient taxation system. However, under the current constitutional arrangements, control of key job creating powers are reserved. We currently control, for example, just 7 per cent of tax revenues raised in Scotland.

It is not just in the transfer of reserved powers themselves where there would be positive benefits, but also in the cross-over to existing devolved responsibilities.

For example, without responsibility for welfare policy, the savings delivered by the Scottish Government's actions to improve employment through initiatives such as Modern Apprenticeships, Higher and Further Education funding, and other training and skills programmes accrue to the Treasury and are not available to reinvest in expanding devolved programmes.

The Scotland Act 2012 will still just give the Scottish Parliament responsibility for only 15 per cent of Scottish taxation revenues.

It will allow the Scottish Government to borrow for capital and current expenditure from 2015-16. Such borrowing will be tightly controlled by HM Treasury. Annual capital borrowing will be capped at 10% of the Scottish Capital DEL budget (approximately £230 million a year), will not be able to be re-profiled between years in response to economic priorities, and there will be a limit on total outstanding borrowing of £2.2 billion.

C. Currency union

The Scottish Government believes that it is clearly in the interests of Scotland, and the rest of the UK, for an independent Scotland to share the pound within a monetary union after independence.

The trade links between Scotland and the rest of the UK (with Scotland estimated to be rUKs 2nd top trading partner) and the contribution of oil, gas, whisky and other Scottish exports make a substantial contribution to the UK balance of payments and there is an integrated financial services market which benefits both countries.

The Fiscal Commission Working Group identified a range of powers that would be available to an independent Scotland within such a monetary union and concluded:

“Independence would provide a substantial step change in the economic and social policy levers open to future Scottish Governments.”

A successful currency union will provide some constraints on deficit levels and debt levels. However, as indicated by the Fiscal Commission Working Group:–

“Limitations on borrowing and deficits are typically at the composite level, and still allow for flexibilities in the design of the underlying tax system and a range of specific policies suitable for each Member State. Indeed such flexibility is vital to the success of a monetary union as it provides the autonomy and policy levers to target country specific differences (advantages and weaknesses) which cannot be tackled with a common monetary policy.”

Therefore, a currency union would not seriously inhibit the policy freedom and flexibility of an independent Scottish Government. It would instead simply ensure and promote overall financial discipline. When discussing a fiscal sustainability agreement, the Fiscal Commission Working Group state that:

“there is merit in devising a ‘fiscal sustainability agreement’. This should cover both governments and be credible. This would not cover individual taxes and/or spending but overall net borrowing and debt. This would provide the flexibility to develop policies to promote growth and maintain economic performance.”

Moreover, Scotland’s financial position would help ensure that it would be able to meet any conceivable conditions in a fiscal sustainability agreement.

Sustainable finances require clear plans and rules, and the markets and external agencies (IMF, credit ratings agencies) will assess our credibility and ability to adhere to these. The Scottish Government has been clear that it will put in place a fiscal architecture which reflects our principles for long term fiscal sustainability.

Professor David Blanchflower, former external member of the Bank of England Monetary Policy Committee, has said:

“Should the people of Scotland choose independence in next year’s referendum it would make sense for Scotland to enter a formal monetary union

with the rest of the UK with the Bank of England operating as central bank for the common monetary area”.

Independence within a currency union would represent a substantial increase in the economic responsibilities of the Scottish Parliament. A currency union would provide the full flexibility to vary tax and spending decisions to target key opportunities and challenges in Scotland – powers that are currently unavailable to the Scottish Parliament.

D. Policy Levers in an Independent Scotland

The benefits of integrated policy

The lack of policy levers has constrained the ability of Scotland to perform as well as it could have over the past few decades. Many small European countries were able to implement customised economic strategies involving a wide range of policy levers alongside incentives for innovation and R&D, all of which were aligned well with education policy and set within a tailored set of industry regulations. These strategies were able to focus on each nation’s specific strengths and addressed any barriers facing them.

It has not been possible to pursue this kind of strategy in Scotland because the gaps in policy responsibility have constrained the options open to the Scottish Government and removed the potential to develop policies with greater synergies. With independence, the Scottish Government could deliberately position Scotland as a key competitor in the global economy. This is likely to have a significant effect on our economic performance.

The key issue is that independence would allow expenditure and tax policy to work together in harmony. Policies are likely to be more effective if public expenditure is able to work in tandem with reforms to the tax, welfare or benefits system. Furthermore, there is a greater incentive to deliver policies in a cost-effective manner because independence would ensure that any savings could be re-invested in funding additional expenditure priorities or future reductions in taxation in Scotland.

Remaining in the UK, the economic challenges with which we are confronted mean that many firms and a large segment of the working population (current and future) face the prospect of declining standards of living, more constrained and insecure jobs, and ever greater competition for what good jobs are available.

The current devolution framework means that Scotland only has some of the powers it needs while others remain in Westminster. This disjointed approach stops a Scottish Government from linking actions together to provide a coherent, effective solution to so many of our existing problems. So, while we can help train our present and future workforce, equipping them with the skills and knowledge they need, we have no say in how they are treated once they are in a job. We have no powers, for example, over a living wage, over gender and worker representation on company boards, or over tax incentives to encourage companies to take on more workers. Practical examples in countries like Norway and Germany show that this not only benefits workers, but also helps companies and the economy grow.

Nor can we act to improve the situation if people find themselves out of work. A simpler, fairer, more accessible and easily understood benefits system, aligned with measures that allow people to move more quickly and easily back into work would help create the confidence, security and sense of stability that leads to a better overall economic performance.

We have already accomplished so much by combining the powers we have, for example by streamlining the planning system, simplifying business regulation and consulting on the streamlining of the rating system, all at the same time as retaining the Small Business Bonus Scheme – which has helped tens of thousands of small businesses. With the full range of powers that independence would give, we could achieve so much more.

For example, modelling by the Scottish Government highlights that a three per cent cut in corporation tax could increase the level of output by 1.4%, boost overall employment in Scotland by 1.1% (equivalent to 27,000 jobs) and raise overall investment in the Scottish economy by 1.9% after 20 years⁶⁰.

Fiscal Levers

The Fiscal Commission Working Group identified the types of fiscal levers that could be used to boost growth, address inequality and stabilise the economy. These include:

- Oil and Gas Taxation
- Excise Duty
- Value Added Tax (VAT)
- Air Passenger Duty
- Capital Borrowing
- Welfare and Social Security
- Corporation Tax (base and rate)
- Public Sector Pay/Pensions
- Capital Gains Tax
- Rural and Environmental Taxation

Non-fiscal levers

As well as tax powers, the Fiscal Commission Working Group set out a range of non-fiscal levers which can be used, or influenced, to secure comparative advantage and boost economic growth and job creation.

⁶⁰ Scottish Government (2011) – Devolving Corporation Tax in the Scotland Bill
<http://www.scotland.gov.uk/Resource/Doc/919/0120770.pdf>

In many cases, fiscal policy measures will be the main type of instrument used to incentivise particular actions. However, there are a range of non-tax policy measures, which can be used to incentivise behaviour and boost economic growth.

These measures can often complement taxation policies. For example, fiscal policy decisions, such as changes to corporation tax in Scotland, could be complemented by other policy levers, such as information, regulation and public provision.

Some of the key non-fiscal levers include:

- Consumer Protection
- Industry Regulation
- Energy Markets and Regulation
- Implementation of EU Legislation
- Competition Law
- International Trade
- Immigration
- Public Provision and Procurement

The Scottish Government is setting out its position on these issues in a range of papers and has already published proposals for a simpler and more co-ordinated approach to economic regulation⁶¹

Rather than simply replicating the full suite of UK economic regulatory bodies, an independent Scotland could bring these functions together and simplify the regulatory landscape to one that is more appropriate for a country of Scotland's size.

This would allow, for the first time, economic and competition regulation in the vital sectors of energy, communications, transport, water and competition to be focused on delivering benefits for Scottish customers and the Scottish economy. Industry would benefit from dealing with fewer regulatory bodies and from greater stability and consistency in regulatory decisions.

Consumers would benefit from having a more powerful regulator acting on their behalf with strong powers to ensure that markets are working efficiently in Scotland. The costs of regulation to industry and the public purse would be minimised, ensuring efficient government. Our initial analysis shows cost savings as compared to replicating the UK system.

Moreover, as consumers are at the heart of competition and regulation, independence would provide an opportunity to build a model of consumer protection which is more likely to meet the needs of Scottish consumers than the current UK system, which is shaped by UK priorities.

⁶¹ *Economic and Competition Regulation in an independent Scotland*
<http://www.scotland.gov.uk/Resource/0041/00415411.pdf>

Similarly, a full range of employment-related powers would enable an independent Scotland to look at innovative ways to support improvements in the productivity and well-being of the workforce. The UK Government is unusual in not having an integrated focus on workplace development, innovation and skills utilisation to better align the supply of skills with the needs of employers.

Evidence from other countries suggests that significant benefits can flow from policies like these⁶². Scotland has very limited scope to pursue such policies at present.

Achieving the business benefits available from integrated improvements in job design, work organisation, and management styles has potential for a major positive impact on skills, innovation, and productivity. In an independent Scotland, business, the education sector and government would have the ability – and the incentive – to work together to achieve these outcomes. Emerging sectors, such as renewables, and high growth sectors, like life sciences, could be targeted for these initiatives. Scotland's scale, and track record in joined-up working could give us a significant extra edge.

Fiscal incentives could also be used, for example, to provide employer investment in training and development. Employers in the UK sometimes point to the disincentive to investment in training when trained staff are able to move to other jobs. An independent Scotland could choose to offer carefully designed tax reliefs to employers who invested in accredited training, to increase the effectiveness of a wider package of workforce and skills measures. At present, policy levers like these are simply not available.

The Scottish Government has already, within the devolved settlement, adopted a strong social partnership approach, working with the voluntary sector, unions, employer associations and employers directly.

In an independent Scotland we could explore mechanisms to formalise the relationship between Government, employer associations and employee associations. Bringing together labour market regulation and other employment-related areas could increase the ability to have more direct and constructive dialogue across all sectors important to Scotland's economy, including new and emerging sectors, such as renewables, and on key issues, such as the Living Wage.

An independent Scotland could also consider the benefits of bringing together all employment related matters in Scotland under one body, with the possibility for Scotland to have its own Employment Rights Authority, similar to other countries, such as NERA⁶³ in the Republic of Ireland.

As with the Combined Economic Regulator, this type of approach could result in greater consistency and stability for employers and employees, along with the potential for cost savings.

These kinds of policy choices could enable an independent Scotland to tackle some of the key challenges we face.

⁶² (Payne, 2004; Ramstad, 2009a and b; Stone, 2011).

⁶³ <http://www.employmentrights.ie/en/>

Conclusion

Over the next 16 months, people in Scotland will be weighing up a decision on which of two futures they think is best for our country.

An independent Scotland will mean the people who live here and care most about this country will be taking the key decisions about our future.

A Scotland under the Westminster system will ensure politicians sitting in London will continue to be in charge of key areas, such as fiscal policy, European policy, welfare policy, employment policy and many other areas that impact directly on the Scottish economy and job creation.

As an independent country, there will be occasions when it makes sense for both Scotland and the rest of the UK to work together in all our interests, such as in a currency union.

But the evidence presented in this paper is clear.

To make best use of the abundant talent, advantages and resources of Scotland, we need to take certain steps:

- We need to become a more equal, cohesive country, not a more unequal, less cohesive society as is happening now.
- We need to become more internationalist, and more engaged in Europe, not issuing threats about leaving the EU as the current UK government is doing.
- We need to have more joined-up innovative policies, not the fragmentation there is now.

Over the next few months, the Scottish Government will be issuing a range of detailed papers on specific sectors, such as oil and gas and energy, and on policy areas, such as consumer protection, which will set out the opportunities of independence.

We have every reason to be optimistic and confident about our prospects as an independent country.

Ultimately, it means being confident that we can run our country better than anyone else.

Annex A

Scotland's Balance Sheet

April 2013

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Executive Summary

This report provides detailed analysis of Scotland's public finances under the current fiscal framework. The analysis encompasses total public spending, public sector receipts, the net fiscal balance and an implied share of UK public sector net debt. It does not consider wider assets and liabilities.

The table below summarises the analysis contained in this report for 2011-12, the most recent year for which detailed estimates of Scotland's public finances are available.

	Scotland	UK
Public Finance Summary: Scotland and UK 2011-12		
Public Spending		
£ Billions	£64.5	£693.6
% GDP	42.7%	45.5%
Of which Social Protection	14.4%	15.9%
Of which Health	7.3%	7.9%
Of which Education	5.1%	6.0%
Tax Receipts		
£ Billions	£56.9	£572.6
% GDP	37.7%	37.5%
Of which Onshore Revenues	30.7%	36.8%
Of which Offshore Revenues	7.0%	0.7%
Net Fiscal Balance		
£ Billions	-£7.6	-£121.0
% GDP	-5.0%	-7.9%
Relative Net Fiscal Balance (Scotland compared to the UK)¹		
% GDP (Percentage Points)	+2.9%	N/A
£ Billions	+£4.4	N/A
Public Sector Net Debt²		
Per Capita Share - £ Billions	£92	£1,103
Per Capital Share - % GDP	62%	72%
Historic Share - £ Billions	£56	£1,103
Historic Share - % GDP	38%	72%

The analysis assigns Scotland an illustrative geographical share of both North Sea tax receipts and GDP

¹Scotland's estimated relative net fiscal balance is calculated as the difference between the Scottish and UK net fiscal balances as a share of GDP. The estimated relative net fiscal position in cash terms is then derived by multiplying this figure by the cash value of Scottish GDP in 2011-12. Further details are provided in Chapter 4.

²Scotland's notional historic share of UK public sector net debt is estimated based on Scotland's historic estimated annual net fiscal balances since 1980-81 within the UK. Further details are provided in Chapter 4.

1. Introduction and Overview

1.1 This report provides a detailed assessment of Scotland's public finances under the current constitutional framework.

1.2 The report is structured as follows. Chapter 2 sets out both the overall size and structure of public spending for Scotland. Chapter 3 then outlines the estimated composition of public sector revenues in Scotland. Specific focus is given to the contribution that tax receipts from oil and gas production make to Scotland's public finances. Chapter 4 discusses Scotland's estimated overall fiscal balance, the difference between public sector revenue and expenditure, and provides illustrative estimates of Scotland's share of UK public sector net debt.

1.3 Unless otherwise noted, the analysis in this report is undertaken in the context of Scotland's current fiscal framework. It therefore does not consider, for example, the options for taxation and public expenditure under independence.

Key Points

1.4 The key points made in the report are summarised below. In producing the analysis, Scotland is assigned an illustrative geographical share of both offshore oil and gas tax receipts and GDP.

Scottish Public Spending

1.5 Public spending for Scotland was estimated to be £64.5 billion in 2011-12. Responsibility for approximately 60% of the public spending undertaken for Scotland is devolved to the Scottish Government and Scottish local authorities.

1.6 In 2011-12, estimated public spending was equivalent to 42.7% of GDP in Scotland. This is estimated to be lower than in both the UK as a whole (45.5%), and the majority of EU-15 countries. Over the period 2007-08 to 2011-12 as a whole, the ratio of public spending to GDP was estimated to be 43.0% in Scotland, compared to 45.0% in the UK.

Table 1.1: Public Spending as a share of GDP: Scotland and UK (2007-08 to 2011-12)

	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	40.1%	41.7%	46.0%	44.5%	42.7%
UK	40.7%	44.4%	47.4%	46.8%	45.5%

Source: GERS 2011/12

Scottish Tax Receipts

1.7 Total tax revenue in Scotland was estimated to be £56.9 billion in 2011-12. This includes an illustrative geographical share of North Sea tax revenue, equivalent to £10.6 billion.

1.8 It is estimated that 7% of current total Scottish tax receipts are devolved. Most tax powers, such as corporation tax and national insurance, are reserved to the UK Government

1.9 Total Scottish tax receipts in 2011-12 were equivalent to £10,700 per person. This compares to a figure of £9,000 per person in the UK as a whole. On a per capita basis, total tax receipts in Scotland have been higher than in the UK in each of the past five years.

Table 1.2: Total Tax Receipts Per Capita: Scotland and UK (2007-08 to 2011-12)

	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	£10,000	£10,600	£9,100	£9,900	£10,700
UK	£8,900	£8,600	£8,200	£8,800	£9,000

Source: GERS 2011/12 and Scottish Government analysis

Scotland's Overall Fiscal Balance

1.10 Over the past five years Scotland and the UK have both run a fiscal deficit (a shortfall between government revenue and expenditure). This is not unusual. Between 1980 and 2014 there has been only one year when the 35 countries in the OECD as a whole have run an overall fiscal surplus.

Table 1.3: Net Fiscal Balance: Scotland and UK (2007-08 to 2011-12) % GDP

	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	-2.9%	-2.6%	-10.7%	-8.1%	-5.0%
UK	-2.6%	-6.9%	-11.2%	-9.5%	-7.9%

Source: GERS 2011/12

1.11 Scotland's estimated fiscal deficit was smaller than the UK's over the period 2007-08 and 2011-12 as a whole. When expressed in cash terms, this relatively stronger fiscal position was equivalent to £12.6 billion over this period.

1.12 This means that over the past five years, holding everything else constant, Scotland could have had higher spending, for example on infrastructure investment, and/or lower taxation and still had a smaller estimated fiscal deficit than the UK.

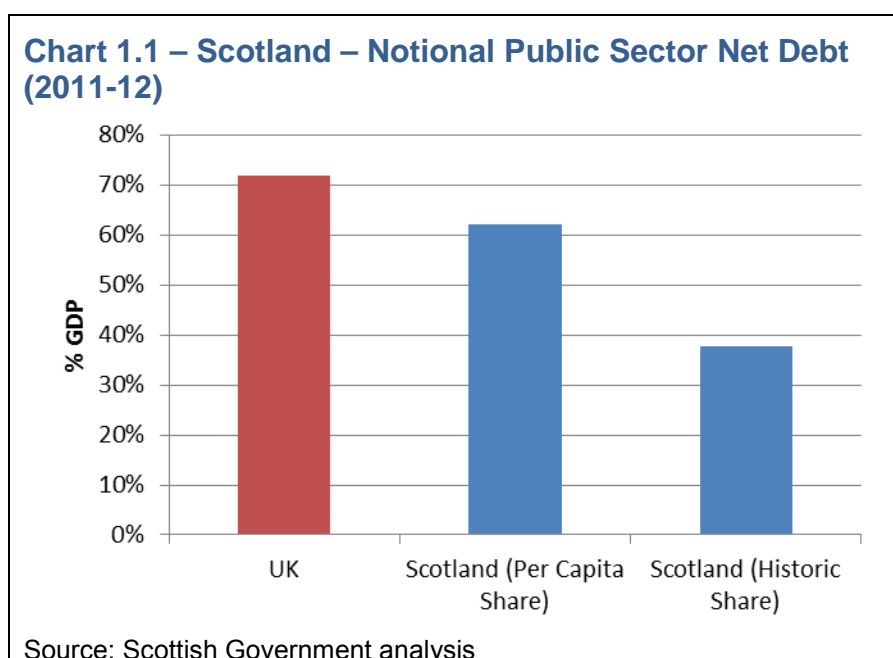
1.13 North Sea revenues account for approximately 16% of Scottish tax receipts between 2007-08 and 2011-12, with onshore receipts accounting for the remaining 84%. Whilst North Sea receipts represent an important revenue source in Scotland, between 2007-08 and 2011-12, they would have had to have been 29% lower than outturn receipts, for Scotland's fiscal deficit to be larger than the UK's.

Scotland's Share of UK Public Sector Net Debt

1.14 UK public sector net borrowing is not incurred for any one country or region in the UK. Therefore, there are no specific outturn figures for Scotland's share of UK public sector debt (i.e. the cumulative stock of public sector net borrowing). Chapter 4 provides two methods of estimating Scotland's notional share of UK public sector net debt, a per capita share and a share based on Scotland's historic fiscal position.

1.15 UK public sector net debt at the end of 2011-12 stood at £1.1 trillion (72% of GDP). Scotland's per capita share would have been equivalent to £92 billion (62% of GDP). This reflects the fact that Scotland has a higher level of GDP per capita (including North Sea oil) than the UK.

1.16 Between 1980-81 and 2011-12, Scotland is estimated to have run a cumulative net fiscal deficit of £49 billion. This equates to 5.1% of the cumulative UK deficit over the same period (£968 billion). Applying this ratio to UK public sector net debt in 2011-12 would result in a notional share for Scotland of £56 billion, equivalent to 38% of Scottish GDP.



2. Public Spending

2.1 This chapter analyses the overall level and composition of public spending in Scotland. The analysis also places the level of public spending in Scotland in the context of other EU countries. Specific focus is given to the aspects of public spending which are reserved to the UK Government. This includes the social security system, defence and debt interest payments.

Public Spending for Scotland

2.2 For 2011-12, the latest year for which detailed statistics are available, total public spending for Scotland by all parts of the public sector (Scottish Government, UK Government and local authorities) was estimated to be £64.5 billion. This includes all spending undertaken by the UK Government on behalf of Scotland, including a share of UK wide public spending such as defence and debt interest. The manner in which total public spending is estimated for Scotland is discussed further in Box 2.1.

2.3 The Scottish Government and Scottish local authorities are responsible for allocating over half (£38.6 billion) of estimated public spending undertaken for Scotland. The UK Government is responsible for the remaining expenditure. Whilst responsibility for allocating over half of public expenditure is devolved, responsibility for setting the overall budget for the Scottish Government is largely reserved to the UK Government and is determined by the Barnett Formula.

Box 2.1 – Quantifying Scottish Public Spending

This report uses data published in the annual Government Expenditure and Revenue Scotland (GERS) report, and adopts the same approach to measuring Scottish public spending.

When quantifying public spending for Scotland, all spending undertaken directly for Scottish residents and businesses by every tier of government, including the UK Government, the Scottish Government and Scottish Local Authorities is included.

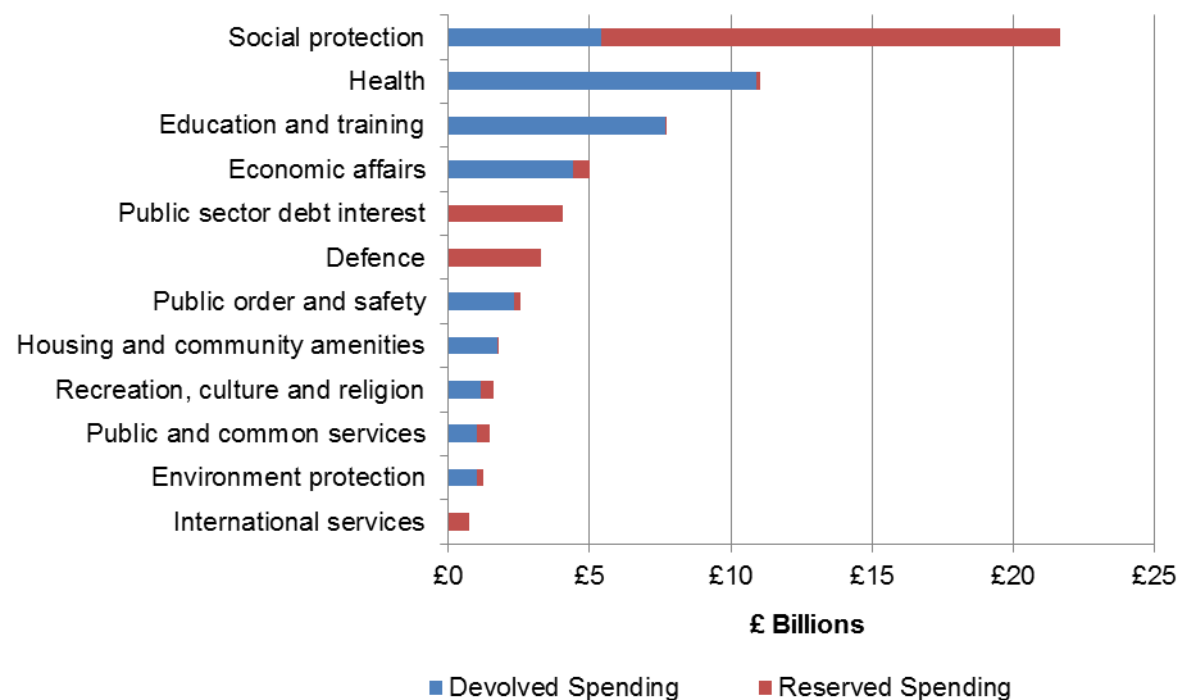
This includes a share of UK wide public spending which cannot be easily identified as benefiting any one specific part of the country. For example, Scotland is allocated a population share of UK defence expenditure, on the basis that all areas of the UK benefit equally from the provision of a national defence service. Likewise, Scotland is assigned a population share of UK debt interest payments and the net cost of the UK Government's financial sector interventions in 2008.

The estimates therefore provide a complete picture of the public spending undertaken for Scotland under the current fiscal framework.

2.4 The chart below details the key categories of public spending for Scotland and the split between devolved and reserved spending. The key areas of public spending which are reserved are aspects of welfare, including the social security system, defence and debt interest payments. Further discussion of each of these areas is provided below. Responsibility for the majority of other areas of public spending is devolved.

2.1 Social protection (which includes social security benefits such as pensions⁶⁴) is the largest single aspect of Scottish public spending, accounting for a third of the total. Health and Education are the second and third largest elements of public spending, accounting for 17% and 12% of the total respectively. Collectively these three categories account for nearly two thirds of overall public spending in Scotland.

Chart 2.1: Total Public Spending: Scotland 2011-12



Source: GERS 2011/12

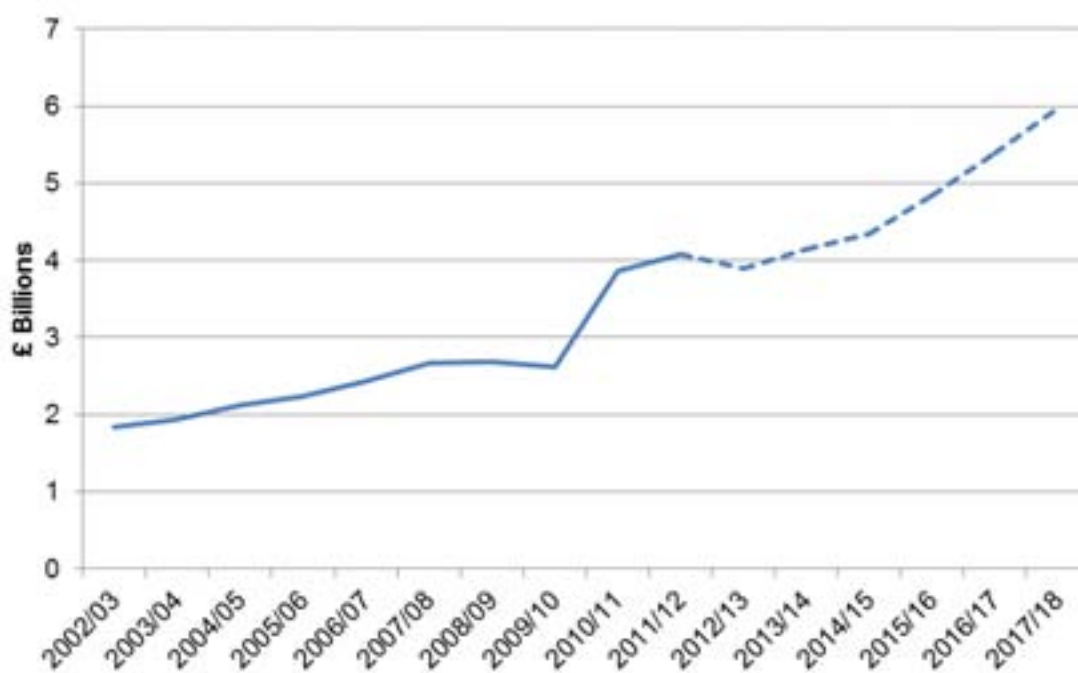
2.2 The composition of public spending for Scotland has remained broadly stable in recent years. However, one notable change has been the increase in spending attributable to debt interest payments.

2.3 The analysis in this report assigns Scotland a population share of UK debt interest payments, irrespective of the relative strength or otherwise of Scotland’s fiscal position. This is consistent with the approach taken in GERS. The recent deterioration in the UK public finances has increased the expenditure on debt interest payments assigned to Scotland from £1.8 billion in 2002-03 to £4.1 billion in 2011-12, as summarised in Chart 2.2. This represents a real terms increase of 79%.

2.4 UK debt interest payments are forecast to rise further in the coming years as a result of the increase in UK public sector net borrowing which has occurred since the recession. As illustrated in Chart 2.2, Scotland’s per capita share of UK debt interest payments is estimated to rise to approximately £5.4 billion by 2016-17 based on current forecasts for the UK public finances.

⁶⁴ In this report the term social security benefits refers to all cash benefits provided to individuals including the state pension, tax credits and working age benefits.

Chart 2.2: Scotland's Population Share of UK Debt Interest Payments



Source: GERS 2011/12 and Scottish Government analysis. Dashed line denotes forecasts

Public Spending as a Share of GDP

2.5 When comparing the level of aggregate public spending across countries or over time, the standard approach is to compare the ratio of public spending to GDP.⁶⁵ This allows the size of the public sector to be compared whilst controlling for the size of the economy.⁶⁶

2.6 In 2011-12, total public sector expenditure for Scotland was estimated to be equivalent to 42.7% of GDP. In comparison, for the UK as a whole public spending was equivalent to 45.5% of GDP. This means that relative to the size of the economy, public spending was estimated to be lower in Scotland than in the UK. To put this into context, the amount allocated by the UK Government for Scottish public spending in 2011-12 would have to have been £4.1 billion higher for the ratio of spending to GDP to match the UK.

2.7 As outlined in the table below, public spending as a share of GDP in Scotland has been lower than in the UK in each of the past five years. Over the period 2007-08 to 2011-12 as a whole, the ratio of public spending to GDP was 43.0% in Scotland, compared to 45.0% in the UK.

⁶⁵ The estimates of Scottish GDP used in this publication are produced as part of the Scottish National Accounts Project and assign Scotland an illustrative geographical share of North Sea oil and gas production

⁶⁶ This measure does not provide an indication of the contribution that the public sector makes to the economy. This is instead captured through the share of gross value added which can be attributed to the public sector.

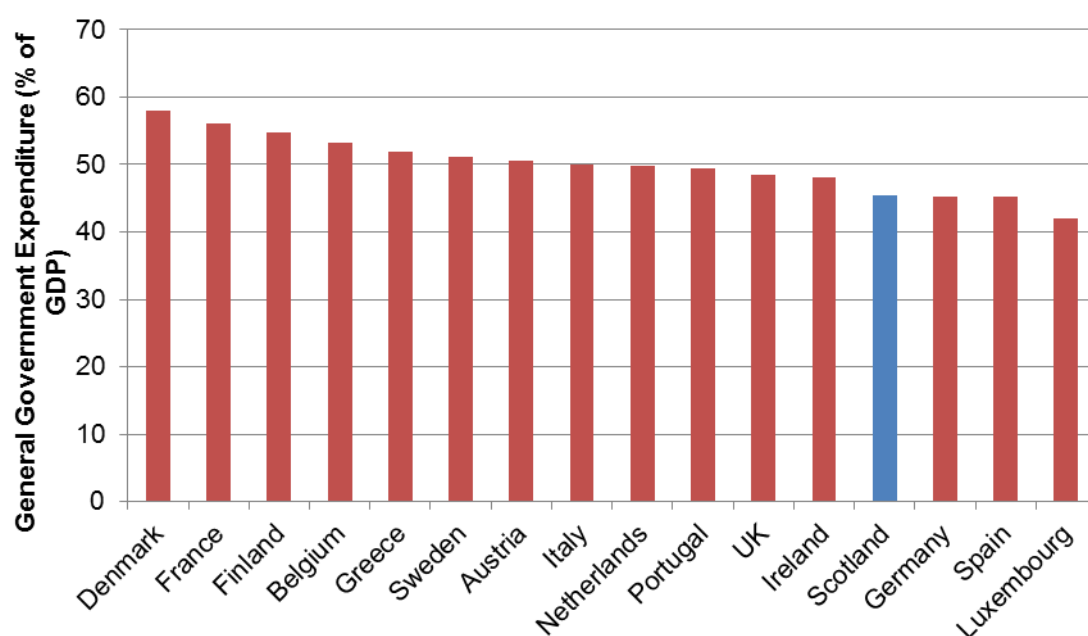
Table 2.1: Public Spending as a share of GDP: Scotland and UK (2007-08 to 2011-12)

	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	40.1%	41.7%	46.0%	44.5%	42.7%
UK	40.7%	44.4%	47.4%	46.8%	45.5%

Source: GERS 2011-12 and Scottish Government analysis

2.8 Chart 2.3 illustrates the ratio of public spending as a share of GDP in Scotland and the EU-15 countries. As the chart illustrates, on an internationally comparable basis the ratio of public spending to GDP in Scotland was estimated to be lower than in the majority of EU-15 countries in 2011⁶⁷.

Chart 2.3: Public Spending as % GDP: EU-15 2011



Source: Eurostat (Total General Government Expenditure as % of GDP) and Scottish Government.

Social Protection Expenditure for Scotland

2.9 Social protection is the single largest category of public spending for Scotland. It encompasses a range of spending functions that are devolved including social services. However, the largest single element of expenditure in this category is spending on social security benefits, which is reserved to the UK Government.

⁶⁷ The ratios of Scottish public spending to GDP in Table 2.1 and Chart 2.3 are calculated on a different basis to ensure that the latter is directly comparable with other EU-15 countries. Eurostat does not produce figures for Scotland. As such the figure for Scotland in Chart 2.3 is based on the ratio of UK public spending as calculated by Eurostat and the comparable figure for the UK as published in GERS.

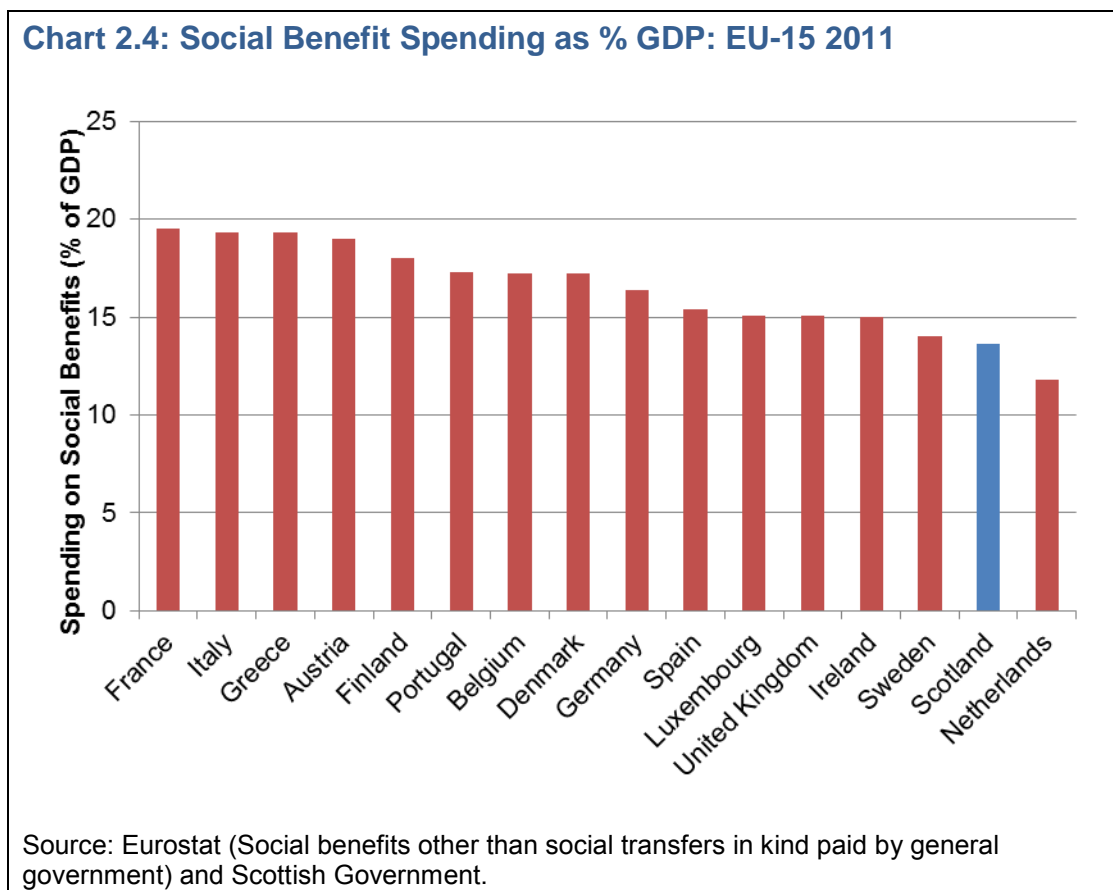
2.10 Total spending on social protection in Scotland during 2011-12 was estimated to be £21.7 billion, of which the UK Government was responsible for £15.9 billion. As outlined in Table 2.2, expenditure on social protection as a share of GDP is estimated to have been lower in Scotland than in the UK in each of the past five years. As a share of total tax revenue, spending on social protection in Scotland was also lower than the UK average in each year between 2007-08 and 2011-12.

Table 2.2: Social Protection Spending as a Share of GDP (2007-08 to 2011-12)

	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	12.4%	13.2%	15.0%	14.5%	14.4%
UK	13.2%	14.4%	15.9%	15.7%	15.9%

Source: GERS 2011/12 and Scottish Government analysis

2.11 Comparing spending on social protection across countries is complicated by differences in the structure of government and the provision of welfare transfers. However, combining the results in Table 2.2 with internationally comparable data from Eurostat suggests that spending on social benefits in Scotland is estimated to have been lower, as a share of GDP, than in the majority of EU-15 countries during 2011.

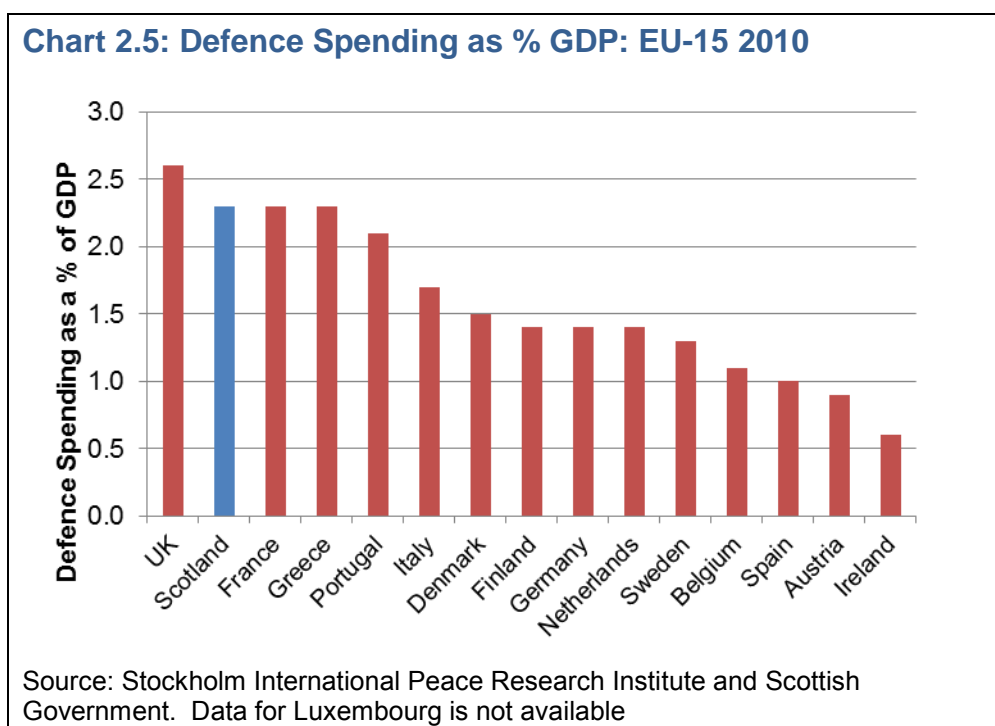


Scotland's share of UK Defence Expenditure

2.12 Defence is the second major aspect of Scottish public spending which is reserved to the UK Government. GERS assigns Scotland a population share of UK wide expenditure on defence on the basis that spending on UK defence facilities benefits all residents of the UK equally, regardless of where the expenditure actually occurs. For consistency the same approach is taken in this report.

2.13 Scotland's population share of UK defence expenditure is equal to £3.3 billion in 2011-12. This is higher than the estimated level of defence expenditure which occurs directly in Scotland⁶⁸. When measured as a share of GDP, it is also high by international standards.

2.14 Chart 2.5 provides estimates of defence expenditure as a share of GDP across the EU-15 in 2010, the most recent year available. Scotland's population share of UK defence expenditure is equal to 2.3% of GDP. As Chart 2.5 highlights, this is higher than all other EU-15 countries, with the exception of the UK as a whole. It is also higher than the ratio of defence expenditure to GDP in many countries of a comparable size to Scotland. For example, in Ireland and Denmark defence expenditure accounts for approximately 0.6% and 1.5% of GDP respectively. As an illustration, if defence spending for Scotland was in line with the EU-15 average (1.5% of GDP) it would suggest defence expenditure of approximately £2.2 billion in 2010-11, £1.1 billion lower than Scotland's current population share of UK spending, rising to approximately £2.5 billion by 2016.



⁶⁸ Previous Scottish Government analysis has shown that Ministry of Defence expenditure in Scotland over the five years to 2006-07 was £4.3 billion less than its population share of defence spending to Scotland over the same period. See for example Your Scotland Your Voice Pg 121 <http://www.scotland.gov.uk/Resource/Doc/293639/0090721.pdf> More recent analysis shows that between 2007-8 and 2011-12, Scotland received £3.17 billion of the defence contracts which are protected from European Union competition rules – approximately £1.9 billion lower than a population share

Conclusion

2.15 Total public spending for Scotland was £64.5 billion in 2011-12. This includes all spending by the Scottish Government, Scottish Local Authorities and the UK Government undertaken on behalf of Scotland, including a share of spending on public services for the benefit of the UK as a whole, such as defence.

2.16 As a share of GDP, public spending is estimated to be lower in Scotland than in the UK as a whole, and in many other EU-15 countries. Social protection, which includes spending on the benefit system, is also lower, as a share of GDP, in Scotland than in the UK, and most other EU-15 countries.

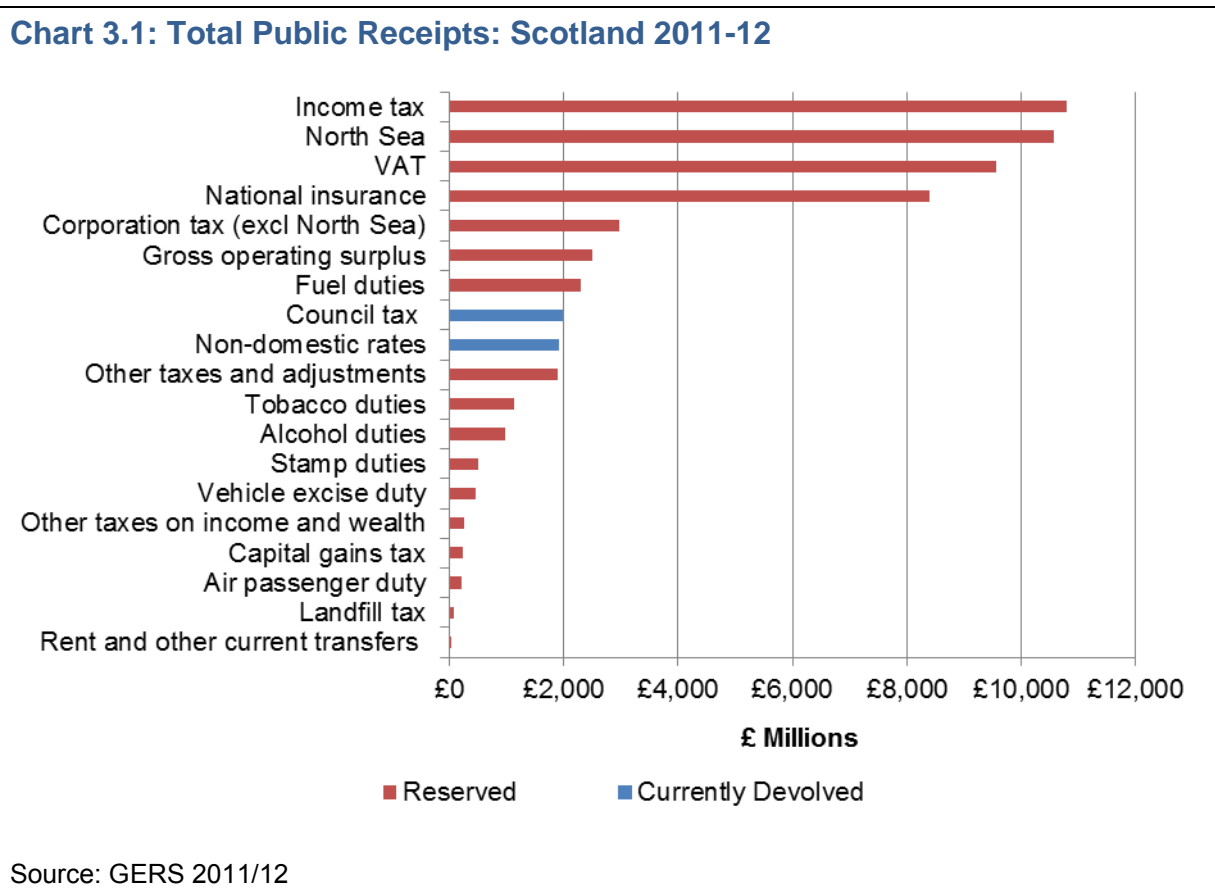
2.17 The analysis in this chapter assigns Scotland a population share of UK spending on defence. The UK has the largest defence budget in the EU-15, as a share of GDP. Scotland's population share is equivalent to £3.3 billion. If defence spending in Scotland was aligned to the EU-15 average, it would be approximately £2.2 billion.

3. Scottish Tax Revenue

3.1 This chapter assesses the composition of tax receipts in Scotland. Particular focus is given to the contribution made by tax receipts from oil and gas production. As outlined in Chapter 1, the analysis assigns Scotland an estimated geographical share of North Sea revenues.

Scottish Tax Receipts

3.2 In 2011-12, total tax revenue generated in Scotland (onshore and offshore) was £56.9 billion.⁶⁹ Chart 3.1 provides a breakdown of revenue by source. Income tax is estimated to be the largest onshore source of tax revenue in Scotland, raising £10.8 billion in 2011-12, 19% of the Scottish total. VAT and National Insurance Contributions were the second and third largest sources of onshore revenue, generating 17% and 15% of total estimated Scottish receipts respectively.

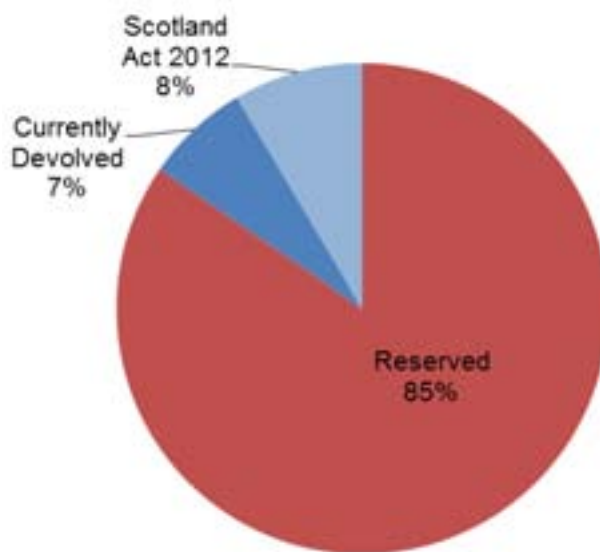


3.3 Chart 3.1 also outlines the proportion of tax revenue which is currently devolved and reserved. At present, responsibility for council tax and non-domestic rates are devolved. Collectively these two taxes accounted for 7% of total Scottish receipts in 2011-12.

⁶⁹ The analysis in this report assigns Scotland an illustrative geographical share of North Sea revenue. For a further discussion of this issue see Chapter 4 of Government Expenditure and Revenue Scotland <http://scotland.gov.uk/Resource/0041/00415871.pdf>

3.4 The Scotland Act 2012 will devolve responsibility for Landfill Tax and Stamp Duty Land Tax from April 2015. It will also introduce, under the current constitutional framework, the Scottish Rate of Income Tax from April 2016 which will devolve some responsibility for aspects of income tax. However, even once the taxes devolved via the Scotland Act are implemented, it is estimated that responsibility for 85% of Scottish tax receipts will remain reserved to the UK Government as outlined in Chart 3.2. Moreover, key tax levers, such as corporation tax, capital gains tax and national insurance, will remain reserved to the UK Government.

Chart 3.2 –Reserved and Devolved Taxation



Source: GERS 2011/12 and Scottish Government calculations

3.5 Total Scottish tax receipts can be disaggregated into onshore and offshore revenue. In 2011-12, onshore taxes generated an estimated £46.3 billion in revenue. This is equivalent to 8.2% of total onshore UK tax receipts, which is broadly in line with Scotland’s share of the UK population.

3.6 Offshore tax revenue refers to the taxes levied on the profits generated by offshore oil and gas producers in UK waters. The North Sea oil and gas industry represents an important source of tax revenue. In 2011, approximately 78% of combined UK oil and gas production is estimated to have occurred in Scottish waters⁷⁰. Scotland’s share of offshore tax revenue is estimated to have been larger, reflecting the relative profitability of fields within the Scottish boundary. In 2011-12, oil and gas production in Scottish waters is estimated to have generated £10.6 billion in tax revenue, 94% of the UK total.

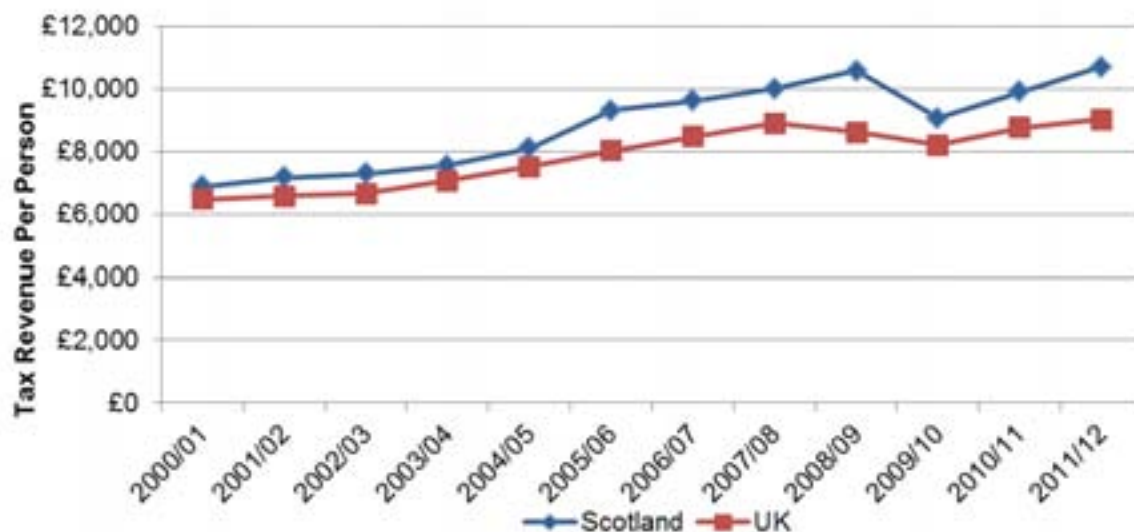
3.7 Total tax revenue (onshore and offshore) in Scotland was equivalent to £10,700 per person in 2011-12, compared to £9,000 in the UK as a whole. As Chart 3.3 illustrates, whilst tax revenue per head in Scotland has varied year on year, it has been consistently higher than the UK average over the past decade.

3.8 Longer term analysis estimates that total tax revenue per person in Scotland was higher than the UK average in each year between 1980-81 and 2011-12. Since 1980-81, total tax revenue per capita in Scotland has been on average £800 a year higher than in the UK as a whole. Adjusted for inflation, the gap has averaged

⁷⁰ The estimates draw on analysis by Professor Alex Kemp from the University of Aberdeen to apportion oil and gas production to Scotland. The analysis base the Scottish boundary of the UK Continental Shelf on the median line principle. This is the same approach that was used in 1999 to determine the boundary between Scotland and the UK for fishery demarcation purposes. Other alternative methods of demarcation are possible.

£1,350 over this period. This reflects the relative contribution of offshore revenues to the Scottish and UK public finances.

Chart 3.3: Tax Revenue Per Person: Scotland and UK



Source: GERS Historic Time Series Dataset and Scottish Government Calculations

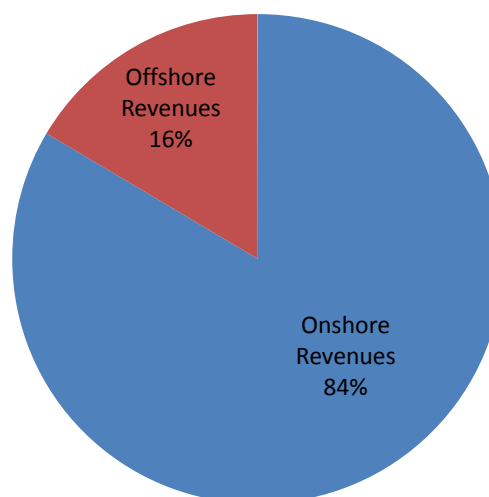
North Sea Revenue

3.9 Scotland is a major oil and gas producer. In 2010 Scotland was the largest combined producer of oil and gas in the EU.

3.10 Oil and Gas UK estimate that there are up to 24 billion recoverable barrels of oil equivalent remaining in the North Sea⁷¹. Scottish Government analysis suggests that remaining oil and gas reserves could have a wholesale value of up to £1.5 trillion. This implies that, by value, more than half of the oil and gas reserves in the North Sea could yet be extracted.

3.11 Analysis by Wood McKenzie suggests that approximately 85% of remaining UK oil and gas reserves lie in Scottish waters.⁷² The oil and gas sector will therefore remain an important part of the Scottish economy for decades to come.

Chart 3.4 – Scottish Tax Receipts 2007-08 to 2011-12 (Onshore/Offshore Split)



Source: GERS 2011/21

3.12 As outlined above, it is estimated that 94% of UK oil and gas tax revenue was generated from production in Scottish waters during 2011-12. In recent years, Scotland's share of North Sea revenues is estimated to have ranged from £11.8 billion in 2008-09 to £5.9 billion in 2009-10. However, despite the fall in revenues

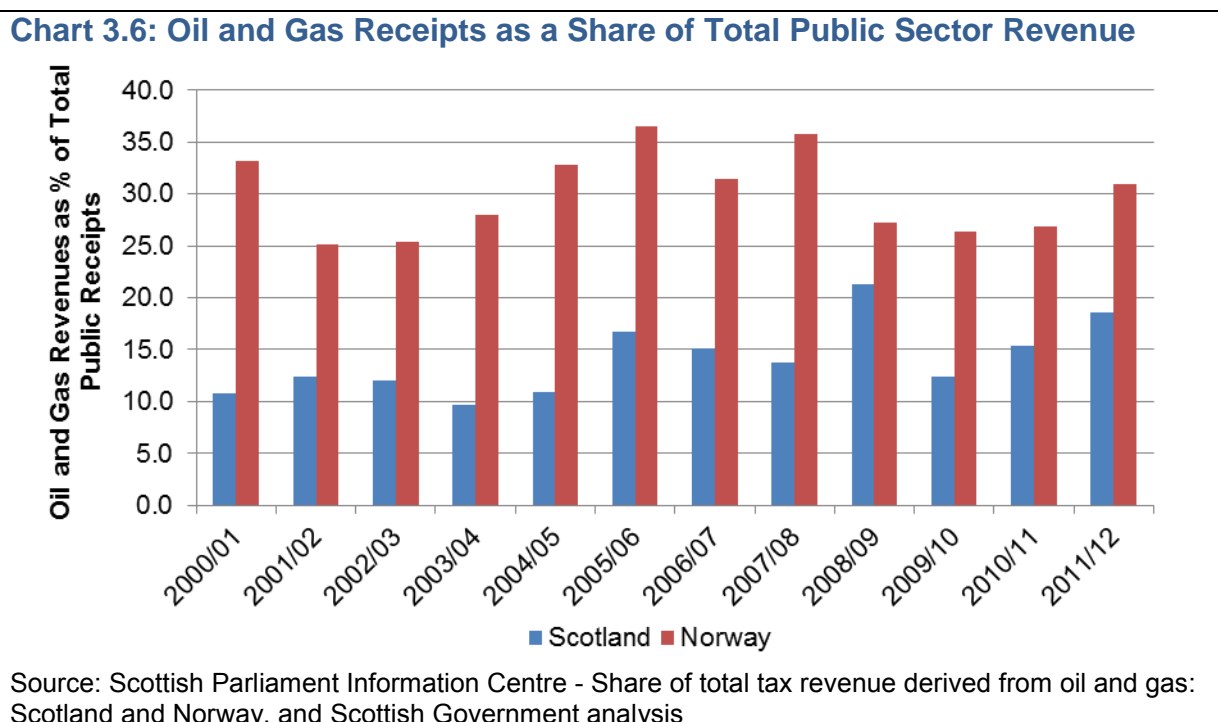
⁷¹ Oil Gas UK – Economic Report 2012

⁷² Wood McKenzie (2012) - Scottish Independence and the Oil & Gas Industry Key Considerations

between these years, Scotland remained in a relatively stronger fiscal position than the UK. This is discussed further in Chapter 4.

3.13 Over the period 2007-08 to 2011-12 as a whole, oil and gas revenues from Scottish waters amounted to £43.4 billion. This is equivalent to 16% of total Scottish tax revenues over the period.

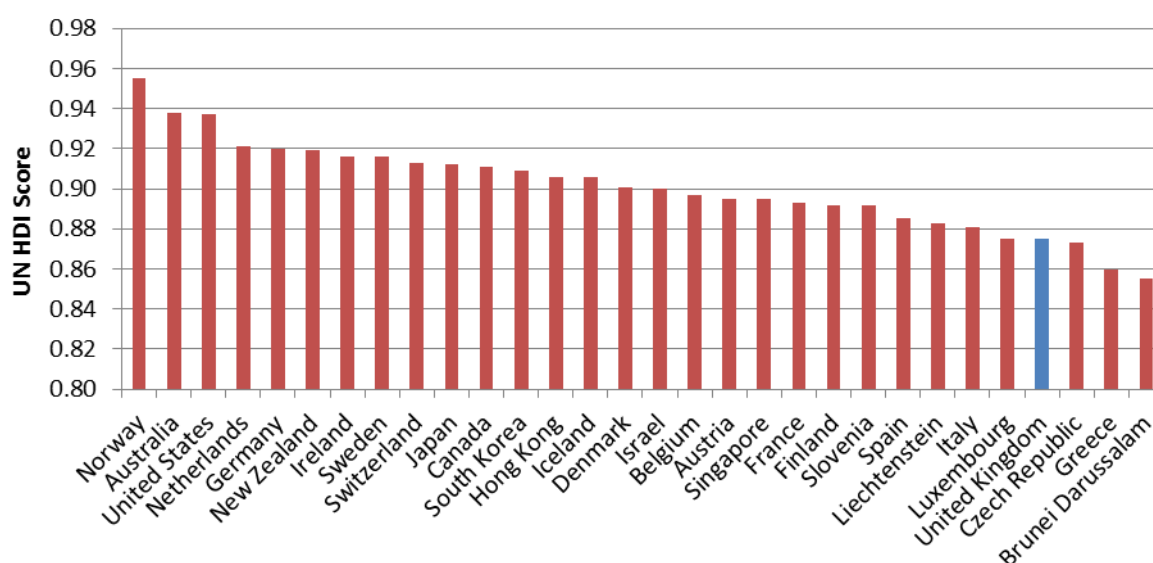
3.14 Whilst oil and gas receipts represent an important source of Scottish tax revenue, they account for a smaller proportion of revenue than in some other major oil and gas producing countries. As an illustration, Chart 3.6 shows the proportion of total public sector revenue attributable to oil and gas production in Scotland and Norway, the largest oil and gas producer in Europe. As the chart demonstrates, oil and gas production accounts for a higher proportion of public sector receipts in Norway compared to Scotland.



3.15 Norway is an interesting case study of the choices that can be made with regard to managing oil and gas revenues.

3.16 GDP per capita in Norway is among the highest in the world. The country is also ranked top of the UN Human Development Index, which provides a broader measure of standards of living, as outlined in Chart 3.7. Norway has also established an oil fund to ensure that its oil and gas resources provide a long term benefit. This issue is discussed further in Box 3.1.

Chart 3.7: UN Human Development Index: 2013 Top 30 Countries



Source: UN Human Development Index

Box 3.1 - Management of Oil and Gas Revenues

A number of countries with substantial finite natural resources have established some form of wealth fund to manage these assets.

The UK and Norway are the largest oil and gas producers in Europe. However, they have taken different approaches to managing the revenue received from the oil and gas industry.

Since 1996 the Norwegian Government has invested a proportion of the revenue received from offshore production in an oil fund. The fund is now worth £450 billion, equivalent to £90,000 per person in Norway, and is the largest Sovereign Wealth Fund in the world. The aim is to ensure that the depletion of Norway's natural assets via oil and gas production are, in part, offset by an increase in its long term financial assets.

In contrast, successive UK Governments have used the revenue generated from oil and gas production to fund current general government expenditure⁷³. This approach has been contrasted with the Norwegian model. For example, Professor Joseph Stiglitz has argued that the UK "squandered" its oil wealth⁷⁴, and that UK Governments' economic policies reflected "false prosperity where they took all the income coming in from the North Sea but rather than investing that in enhancing the human capital, the fiscal capital and the technical skills, a disproportionate amount of that went elsewhere"⁷⁵.

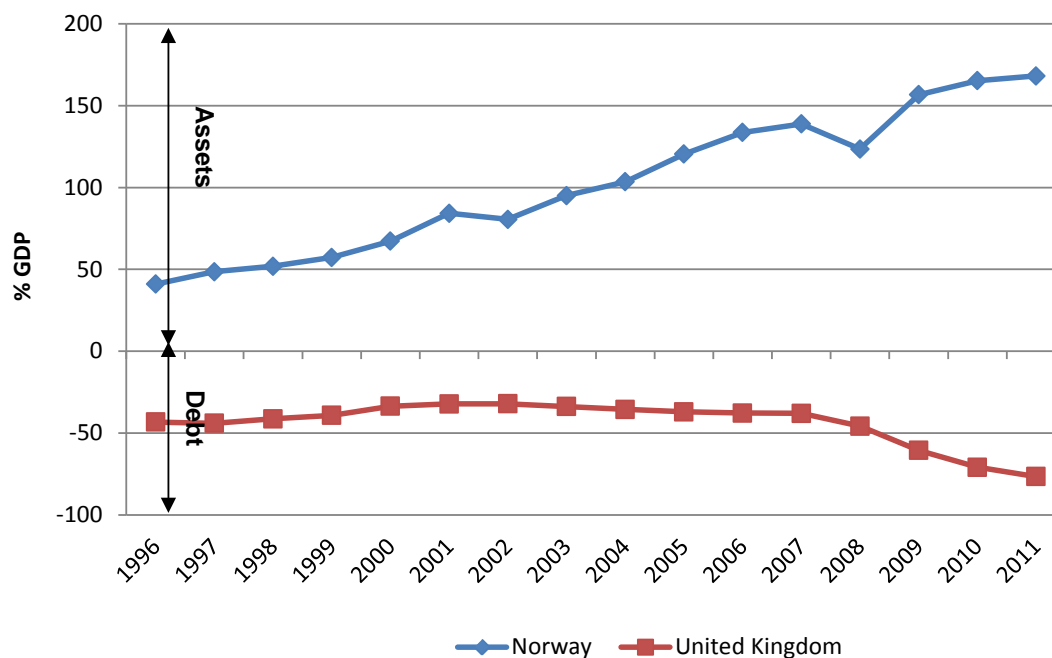
⁷³ Analysis of the extent to which the depletion of a country's natural resources is offset by investment in other types of assets has been provided as part of the World Bank's Genuine Savings analysis and the UN Inclusive Wealth Report.

⁷⁴ Newsnight Scotland – 24 August 2010

⁷⁵ Taken from Professor Stiglitz's evidence of the Scottish Parliament's Economy Committee (28 February 2013) as reported by the Scottish Press Association.

One long term implication of this different approach has been that whilst the IMF estimates that UK general government net debt now stands at around 75% of GDP, Norway has accumulated public sector net assets equal to 168% of GDP, as outlined in Chart 3.8

Chart 3.8: General Government Net Debt: % of GDP Norway and UK



Negative values indicate that public sector liabilities exceed assets. Source: IMF World Economic Outlook Database

Conclusion

3.17 In 2011-12, total tax revenue generated in Scotland (onshore and offshore) was £56.9 billion. At present, responsibility for council tax and non-domestic rates are devolved. Collectively these two taxes accounted for 7% of total Scottish receipts in 2011-12.

3.18 Total Scottish tax receipts can be disaggregated into onshore and offshore revenue. In 2011-12, onshore taxes generated an estimated £46.3 billion in revenue. This is equivalent to 8.2% of total onshore UK tax receipts, which is broadly in line with Scotland's share of the UK population

3.19 Including an illustrative geographical share of oil and gas revenues, total Scottish tax receipts were estimated to be £56.9 billion in 2011-12. This equates to £10,700 per capita, compared to £9,000 in the UK as a whole.

3.20 Total tax revenue per person in Scotland is estimated to have been higher than the UK average in each year between 1980-81 and 2011-12. Since 1980-81, total tax revenue per capita in Scotland has been on average £800 a year higher than in the UK as a whole. Adjusted for inflation, the gap has averaged £1,350 over this period. This reflects the relative contribution of offshore revenues to the Scottish and UK public finances.

4. Overall Fiscal Position and Public Sector Debt

4.1 This chapter assesses Scotland's overall fiscal position. The focus of the chapter is on Scotland's estimated net fiscal balance (the difference between tax revenue and government expenditure) and Scotland's notional share of UK public sector net debt.

Assessing the Sustainability of the Public Finances

4.2 There are two primary indicators of the sustainability of a country's public finances, the annual budget balance and the overall stock of public sector debt.

4.3 The budget balance measures the difference between public spending and tax revenue in a given year. It therefore determines the government's annual borrowing requirement. The stock of public sector debt is the cumulative value of all outstanding debts owed by the government. It is also a factor in determining the amount that a government has to pay each year in interest payments. Both indicators are generally measured as a share of GDP to provide an indication of the scale of debt or deficit relative to the size of the economy.

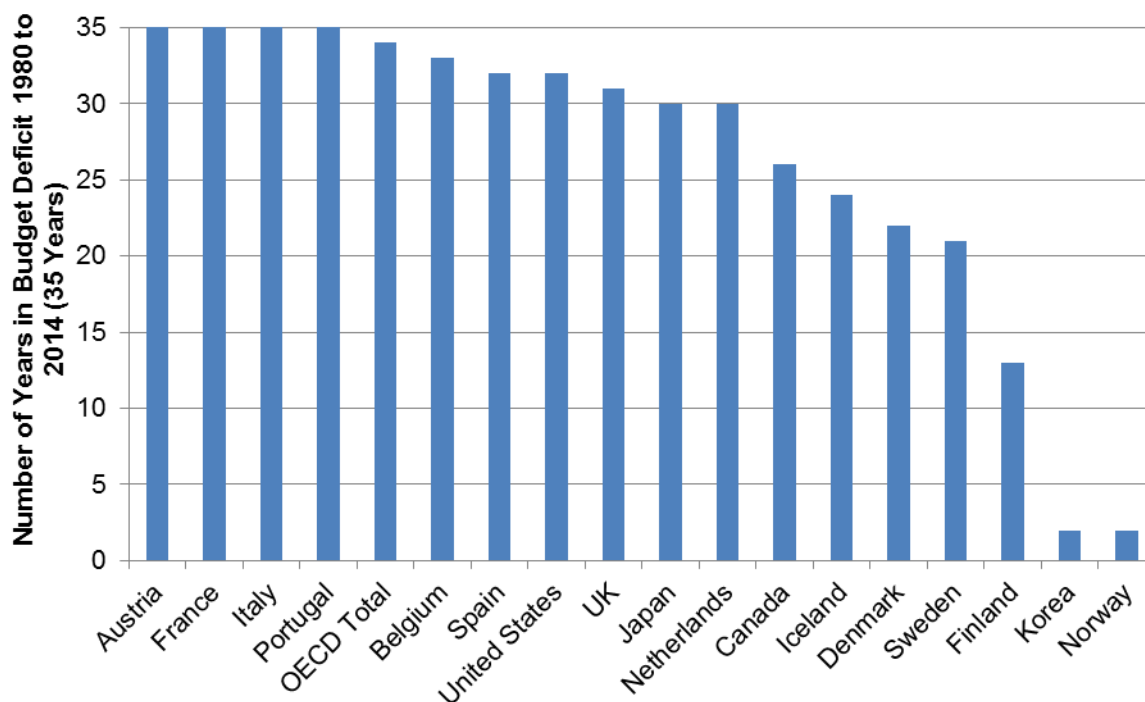
4.4 It is possible for a government to run an annual budget deficit (a shortfall between income and expenditure) in a manner which is sustainable. This is because if the economy is growing quicker than the rate of debt accumulation, the debt to GDP ratio will still fall. As such, the burden of the debt will be reduced, relative to the country's ability to service it.

4.5 The sustainability of a country's public sector debt therefore depends on the rate at which the stock of debt is increasing relative to the growth of the economy. If debt is stable or falling as a share of GDP it is generally sustainable. However, if debt is increasing as a share of GDP this is unsustainable in the long run.

4.6 The prevalence for countries to run net fiscal deficits is reflected in the public finance data collected by the OECD. The OECD provides estimates of the annual budget balances for seventeen of its members for each year between 1980 and 2014. This shows that a number of countries, including France and Austria, are estimated to have run a fiscal deficit in every year during this period. Likewise, the USA and UK have only run budget surpluses on three and four occasions respectively during this period. South Korea and Norway were in deficit for the fewest number of years. In the case of Norway this reflects, in part, their effective use of the tax revenues received from oil and gas production.

4.7 Looking at the aggregate public finances of all OECD countries shows that over the 35 year period between 1980 and 2014 there has been only one year when the group as a whole has not run an overall budget deficit.

Chart 4.1 - OECD Countries: Number of Years in Deficit: 1980-2014 (35 Year Period)



Source: OECD Economic Outlook Database

Scotland's Net Fiscal Balance

4.8 The primary estimate of Scotland's overall annual budget balance is the net fiscal balance. The net fiscal balance measures the difference between total public sector expenditure and revenue. It is comparable to the estimates of UK public sector net borrowing published by the Office for National Statistics. An alternative measure of Scotland's fiscal position is the current budget balance, which is also published by the ONS for the UK. This measures the difference between current expenditure and current receipts and is discussed further in Box 4.1.

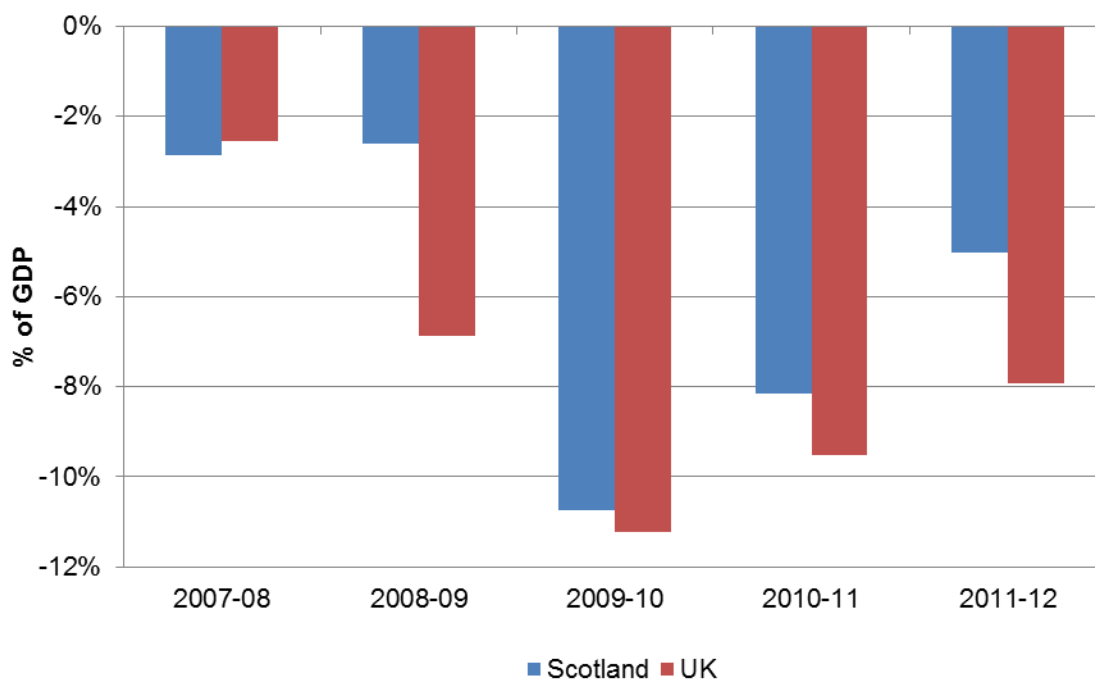
4.9 Scotland's net fiscal balance as a share of GDP in each year from 2007-08 to 2011-12 is outlined in the chart below. The equivalent UK figures are also provided. Two trends are evident from the data.

4.10 Firstly, over the five years to 2011-12 as a whole, whilst in deficit, Scotland was estimated to be in a relatively stronger fiscal position than the UK. Since 2007-08, Scotland has run an average net fiscal deficit of £8.3 billion (5.9% of GDP). During the same period, the UK ran an average annual deficit of £111 billion, equivalent to 7.6% of GDP.

4.11 Secondly, the results in Chart 4.2 demonstrate the impact that the recession has had on Scotland's public finances. In line with many other countries, Scotland has observed a large increase in its net fiscal deficit after 2008-09 as a result of the global recession. This trend is reflected across virtually all advanced economies. Among the 35 members of the OECD, only Norway and Switzerland did not run a fiscal deficit in 2009.

4.12 Box 4.1 provides estimates of Scotland's current budget balance (the difference between current revenue and current expenditure) in the five years from 2007-08 to 2011-12. The results show that over this period Scotland is estimated to have run an average current budget deficit equivalent to 2.9% of GDP whilst the UK ran an average current budget deficit equivalent to 5.0% of GDP.

Chart 4.2 - Net Fiscal Balance: Scotland and UK (% of GDP)



Source: GERS 2011/12

Box 4.1 - Current Budget Balance

The current budget balance illustrates the difference between current revenue and current expenditure. It therefore excludes capital expenditure. The current budget balance measures the degree to which current taxpayers meet the cost of paying for the public services they consume today and a contribution to debt interest payments. If a country is running a current budget balance or surplus it may still have to borrow to fund capital expenditure. However, such borrowing will be for long term investment which can be expected to increase the economy's productive capacity in future years. In effect, no borrowing is being used to fund day to day government services.

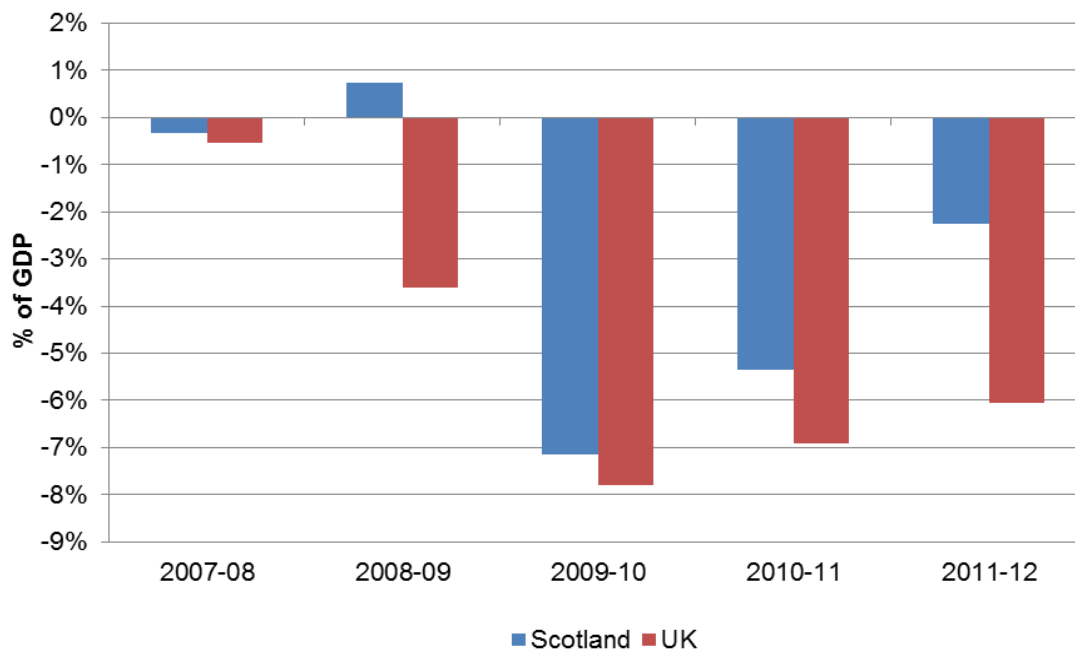
The chart below shows Scotland's estimated current budget balance as a share of GDP since 2007-08. In 2007-08 and 2008-09 Scotland was either running a current budget surplus or a small deficit. In comparison, the UK was in deficit in both years. Looking at earlier years shows that Scotland also ran a current budget surplus in 2005-06 and 2006-07. In comparison, the UK has not run a current budget surplus since 2001-02

Since 2009-10 Scotland and the UK's fiscal positions have deteriorated. This has resulted in both countries running comparatively large current budget deficits in 2009-10 and 2010-11 compared to historical averages. However, as Chart 4.3 illustrates, Scotland continued to run a smaller current budget deficit than the UK.

Scotland has also seen a more rapid recovery in its current budget than the UK. By 2011-12, Scotland's current budget balance was estimated to have fallen to 2.3% of GDP, compared to 6.0% of GDP in the UK.

Looking at the period 2007-08 to 2011-12 as a whole, Scotland ran an average current budget deficit equivalent to 2.9% of GDP. Over the same period, the UK ran an average current budget deficit equivalent to 5.0% of GDP.

Chart 4.3 - Current Budget Balance: Scotland and UK (% of GDP)



Source: GERS 2011/12

Scotland's Relative Fiscal Position

4.13 Under the current constitutional framework aggregate levels of public spending and taxation in Scotland and the UK are inherently linked. Therefore, when analysing Scotland's public finances it is informative to consider Scotland's net fiscal balance relative to the rest of the UK.

4.14 Looking specifically at 2011-12, the most recent year for which data and estimates are available, shows that the UK had a deficit equivalent to 7.9% of GDP. In comparison, Scotland ran a net fiscal deficit equivalent to 5.0% of GDP.

4.15 One way in which the relative financial positions of Scotland and the UK in 2011-12 can be illustrated is by analysing the difference in net fiscal balances as a share of GDP between the two countries. This allows the relative size of the economies to be controlled for when comparing their fiscal positions. In 2011-12 Scotland's estimated deficit was 2.9 percentage points smaller, as a share of GDP, than the equivalent UK deficit. When expressed in cash terms, this difference is equivalent to £4.4 billion, or £824 per person in Scotland.

4.16 Extending this analysis over the past five years shows that Scotland has been in a relatively stronger fiscal position than the UK over this period. When expressed in cash terms, Scotland's relatively stronger fiscal position over this period as a whole is equivalent to £12.6 billion. This equates to £2,375 per person. This means that over the period 2007-08 to 2011-12 as a whole, Scotland could have had higher spending, for example on infrastructure investment, and/or lower taxation and still had a smaller estimated fiscal deficit than the UK.

Box 4.2 - Sensitivity to North Sea Revenue

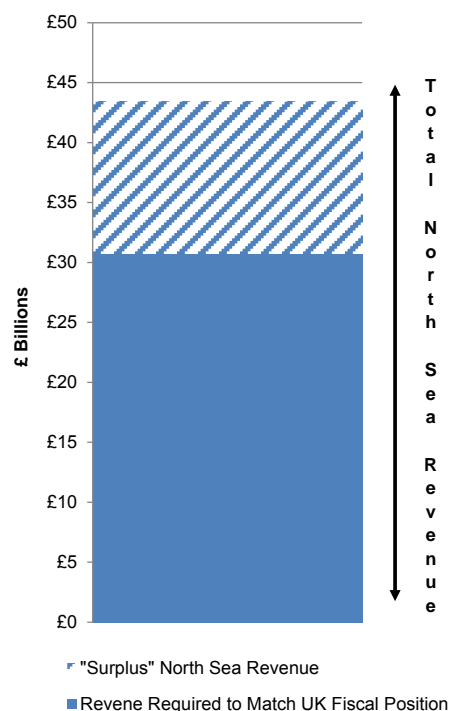
As outlined on Chapter 3, a key difference between the Scottish and UK public finances is the proportion of tax revenue accounted for by oil and gas production.

The primary determinants of offshore tax receipts are the level of production, oil and gas prices and operating and exploration costs. Whilst production has followed a fairly consistent trend in recent years, prices have been more volatile. Oil prices increased from \$55 a barrel at the start of 2007 to a peak of \$140 in July 2008. They subsequently fell to \$35 before returning to over \$100 a barrel in 2012.

These price changes have affected the tax revenue generated by the industry. For example, between 2008-09 and 2009-10 Scottish offshore receipts fell from £11.8 billion to £5.9 billion as oil prices fell following the onset of the global recession. However, despite the 50% fall in North Sea revenues during 2009-10, Scotland continued to have a smaller fiscal deficit, as a share of GDP, than the UK. Scottish oil and gas revenues would have had to have fallen by a further £660 million (11%) for Scotland to have had a larger fiscal deficit than the UK during 2009-10.

Between 2007-08 and 2011-12 as a whole the North Sea contributed £43.4 billion in tax revenue to Scotland, as illustrated in Chart 4.4. Even if North Sea revenues had actually been 29% lower than the outturn, Scotland would still have had a smaller cumulative deficit over the past five years than the UK.

Chart 4.4 Cumulative North Sea Revenue: 2007-08 to 2011-12



Source: GERS 2011/12 and Scottish Government analysis

Public Sector Net Debt

4.17 When considering the sustainability of a country's public finances, it is important to consider the overall stock of debt, as well as the level of borrowing in a specific period.

4.18 Under the current fiscal framework, UK public sector net debt is incurred for the country as a whole, and not directly for Scotland or any other part of the UK. As such, there are no outturn figures for Scotland's share of UK net debt. Two approaches which can be used to allocate a notional share of UK net debt to Scotland are presented below.

Population Share

4.19 GERS allocates Scotland a per capita share of UK debt interest payments. The same approach could therefore be used to allocate Scotland a share of the corresponding debt.

4.20 UK public sector net debt at the end of 2011-12 stood at £1.1 trillion. Scotland's per capita share would have been equivalent to £92 billion (62% of GDP). This would represent a lower debt to GDP ratio than for the UK as a whole (72%), reflecting the fact that Scotland has a higher level of GDP per capita (including North Sea oil) than the UK.

4.21 Scotland's notional public sector net debt in 2011-12 would have to have been £15 billion higher than its per capita share for Scotland to have the same debt to GDP ratio as the UK.

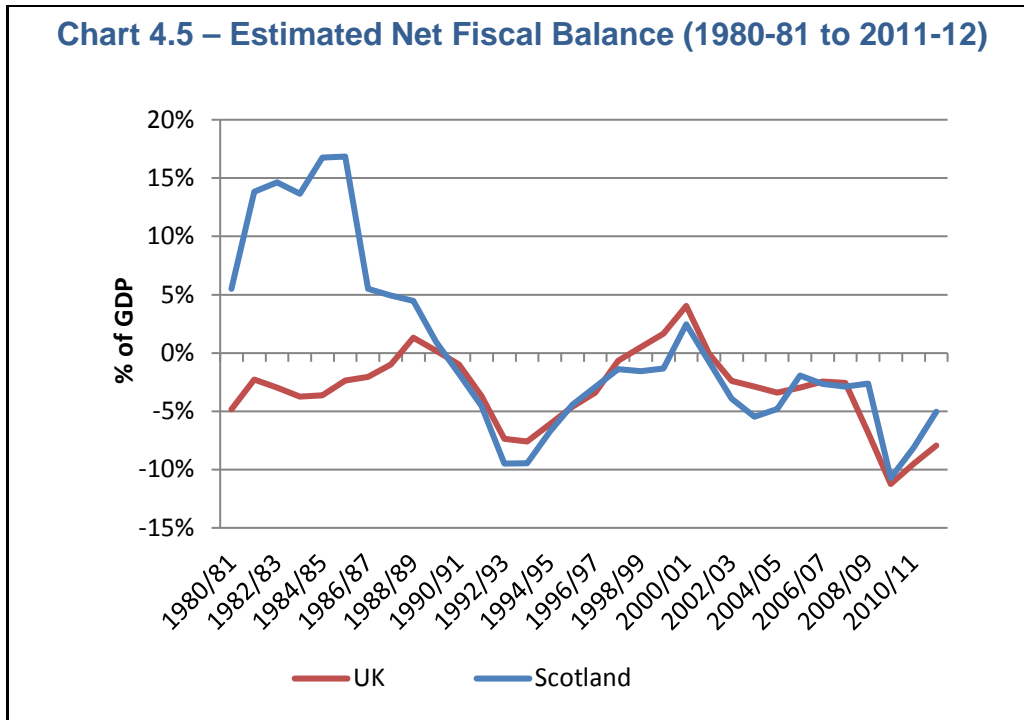
Historic Share

4.22 A country's public sector net debt can be viewed as the sum of its historic annual borrowing, minus any debt repayment. Therefore, an alternative way to calculate Scotland's notional share of UK public sector debt is to base it on Scotland's historical fiscal position.

4.23 Information on aggregate Scottish public spending and tax receipts from 1980-81 onwards on a consistent basis is published on the Scottish Government website⁷⁶. Chart 4.5 provides estimates of Scotland's overall net fiscal balance as a percentage of GDP from 1980-81 onwards using this data. The results show that during the early 1980s, Scotland ran a substantial net fiscal surplus, driven by the significant growth in North Sea revenues. Scotland's fiscal position weakened through the 1990s but since 2001-02 has been broadly in line with that of the UK.

4.24 Over the period 1980-81 to 2011-12 as a whole, Scotland is estimated to have run an average annual net fiscal surplus equivalent to 0.2% of GDP. The UK is estimated to have run an average annual net fiscal deficit worth 3.2% of GDP.

⁷⁶ The dataset is available from <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS/RelatedAreas/LongRunGERS201011> The dataset is classified as experimental

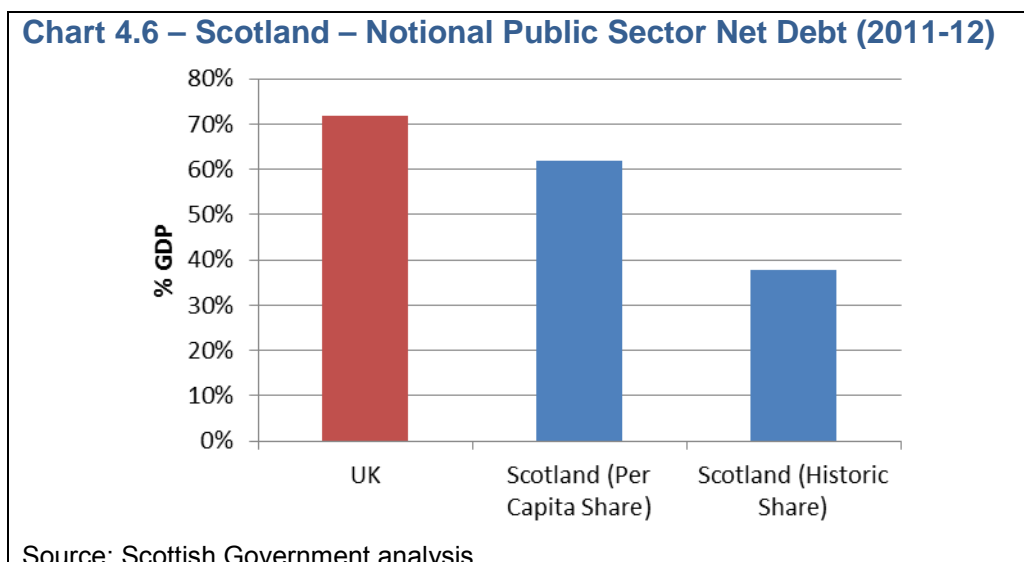


4.25 As approximately 90% of UK public sector net debt has been incurred since 1980, assessing Scotland’s fiscal position over this period gives an indication of the amount of UK net debt which has been incurred on behalf of Scotland.

4.26 Between 1980-81 and 2011-12, Scotland is estimated to have run a cumulative net fiscal deficit equivalent to £49 billion. This means that over this period as a whole, total public spending for Scotland exceeded tax revenue by £49 billion. This equates to 5.1% of the cumulative UK deficit over the same period (£968 billion).

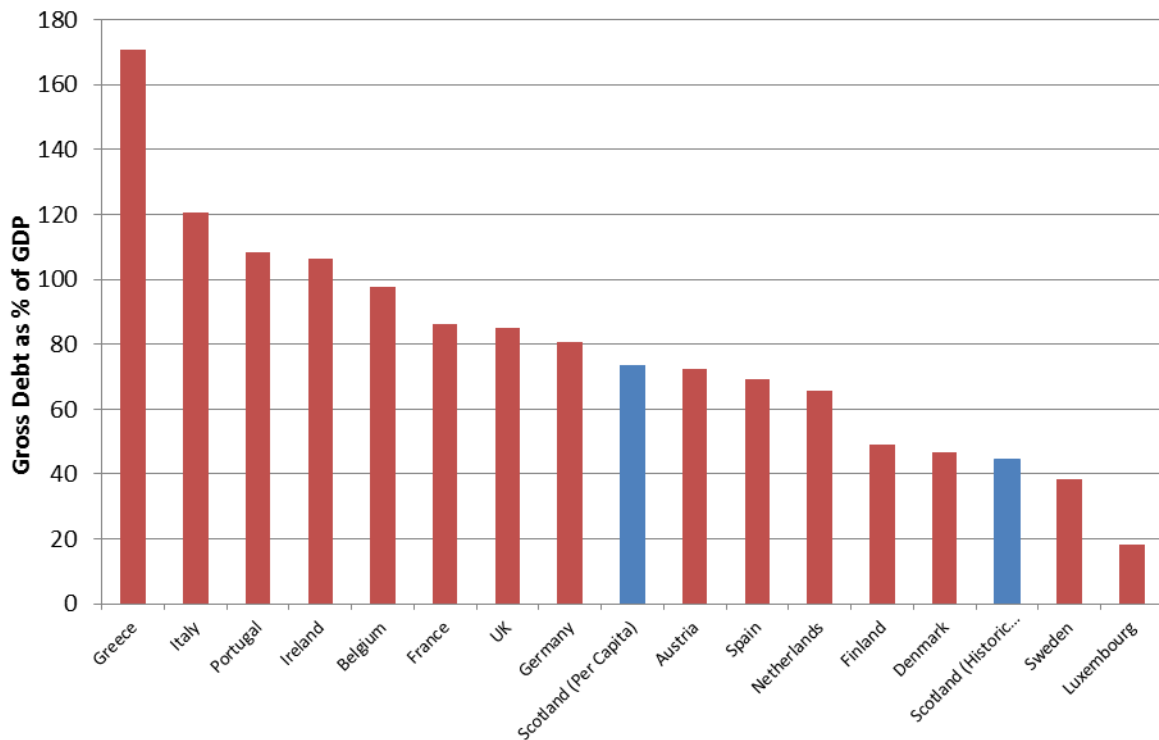
4.27 Applying this ratio to UK public sector net debt in 2011-12 would result in a notional share for Scotland of £56 billion, this is equivalent to 38% of Scottish GDP.

4.28 Chart 4.6 compares the above estimates of Scotland’s share of UK public sector net debt for 2011-12 as a share of GDP. The equivalent UK figure is also included for reference.



4.29 Chart 4.7 shows Scotland's notional share of UK public sector gross debt in 2011 on an internationally comparable basis using the above methodologies. Using either a per capita or historic share of UK debt, Scotland's notional debt to GDP ratio is estimated to be lower than in half the EU-15 countries, including the UK, Germany and France.

Chart 4.7 - General Government Gross Debt: EU-15 (% of GDP)



Source: Eurostat – General Government Gross Debt and Scottish Government analysis

Conclusions

4.30 In summary, Scotland has run an overall net fiscal deficit in recent years, as has the UK. This is common among national governments.

4.31 Despite being in deficit, between 2007-08 and 2011-12 Scotland has been in a relatively stronger fiscal position than the UK. When expressed in cash terms, Scotland's relatively stronger fiscal position compared to the UK during this period is estimated to be equivalent to £12.6 billion. This means that over the past five years, Scotland could have had higher spending, for example on infrastructure investment, and/or lower taxation and still had a smaller fiscal deficit than the UK.

4.32 UK public sector net debt stood at £1.1 trillion (72% of GDP). Two methodologies are set out in this chapter to allocate Scotland a notional share of this debt. Scotland's per capita share of UK net debt is estimated to be £92 billion (62% of GDP). When Scotland's notional share of UK debt is estimated based on Scotland's historical net fiscal balance it is estimated to be worth £56 billion (38% of GDP).

5. Conclusion

5.1 This report has provided a detailed assessment of Scotland's public finances under the current constitutional framework. The key points made in the report are summarised below.

- Public spending for Scotland was estimated to be £64.5 billion in 2011-12, equivalent to 42.7% of GDP in Scotland. This is estimated to be lower than in both the UK as a whole (45.5%), and the majority of EU-15 countries.
- Social protection is the single largest category of public spending for Scotland, and includes spending on social security benefits. Expenditure on social protection as a share of GDP is estimated to have been lower in Scotland than in the UK in each of the past five years
- Total tax revenue in Scotland was estimated to be £56.9 billion in 2011-12. This includes an illustrative geographical share of North Sea tax revenue, equivalent to £10.6 billion. Total Scottish tax receipts in 2011-12 were equivalent to £10,700 per person. This compares to a figure of £9,000 per person in the UK as a whole. On a per capita basis, total tax receipts in Scotland have been higher than in the UK in each year since 1980-81.
- Scotland's ran a net fiscal deficit worth 5% of GDP in 2011-12, lower than the equivalent UK deficit of 7.9% of GDP. Over the five years to 2011-12, Scotland is estimated to have run a smaller overall fiscal deficit than the UK. When expressed in cash terms, this relatively stronger fiscal position was equivalent to £12.6 billion over this period.
- North Sea revenues accounted for approximately 16% of Scottish tax receipts between 2007-08 and 2011-12, with onshore receipts accounting for the remaining 84%. North Sea receipts represent an important revenue source in Scotland. However, between 2007-08 and 2011-12, they would have had to have been 29% lower than outturn receipts, for Scotland's fiscal deficit to be larger than the UK's.
- UK public sector net debt at the end of 2011-12 stood at £1.1 trillion (72% of GDP). Two methods of assigning a notional share of this debt to Scotland are provided in this report. Scotland's per capita share would have been equivalent to £92 billion (62% of GDP). When Scotland's notional share of UK debt is estimated based on Scotland's historical net fiscal balance it is estimated to be worth £56 billion (38% of GDP).



The Scottish
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Riaghaltas na h-Alba

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