CPPR Briefing Note
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CPPR
Centre for Public Policy for Regions

Fiscal implications for an independent Scotland when assuming that it takes on a low, or zero, share of the UK's existing debt

Introduction

In the event that the referendum results in a YES vote, the Scottish Government has tentatively argued it might assume a low, or even zero, share of the UK's current debt liabilities.

There are a variety of arguments that can be put forward as to why a lower than population share, or even no share, of UK debt might be appropriate. These are briefly discussed later in this note. Depending on which of these arguments, if any, prevails, then Scotland could reach such a position, either by mutual agreement with the rest of the UK (RoUK) or by taking a unilateral stance.

Such a position could have a significant impact on Scotland's future fiscal balance. For example, in 2012-13 Scotland's share of the UK's debt interest and loan payments associated with such historic debt was estimated to be £4 billion; 6.5%-7%[1] of Scotland's expenditures. This is expected to rise to over £6 billion by 2018-19.

This Briefing Note[2] outlines the impact of excluding such an expenditure on Scotland's fiscal balance.

The note also considers some of the arguments as to why Scotland might be exempted from assuming any of the UK's existing debt; the knock on impact on any break-up negotiations on the distribution of UK assets and other liabilities of such a zero Scottish debt position; and the lack of analysis by the Scottish Government and its Fiscal Commission on the full fiscal implications of this zero debt position alongside the alternative currency arrangements.

Arguments for Scotland assuming a low, or zero, share of the UK's existing debt

There are a number of arguments that have been put forward as to why Scotland should assume a share of the UK government debt that is less than its population share, or even zero.

[1] Scotland's derived debt interest payments in 2012-13 accounted for 7% of its total expenditure, excluding capital spending, or 6.5% if all capital spending was included.

[2] In order to estimate the impact of such a scenario on Scotland's fiscal balance, we have revised our March CPPR Briefing Note (see http://www.gla.ac.uk/media/media_319446_en.pdf), which used a variety of recently released UK and Scottish Government documents to review Scotland's future fiscal balance (ie, Scotland's public sector revenues minus its expenditures).

(i) Quid pro quo for Scotland not being allowed to share a formal monetary and currency union with the RoUK

This is the Scottish Government's current rationale for potentially assuming zero UK debt. However, the argument is flawed in the sense that sterling, as a means of payment, is not an asset which has a value that can be off-set against Scottish debt obligations. Rather, sterling is more a symbol than an asset, symbolising the UK's economic and fiscal reputation to pay its debt obligations, with a track record of doing so going back to1694, with the establishment of the Bank of England[3].

Hence it is the reputation of sterling, or to be more precise the reputation of the government and central bank that lie behind it, that is of value. As such, a monetary union would come about, or in this case, remain, when all the parties involved wished to work together to make it a success. If either Scotland or the RoUK does not want to do so, then the monetary union, and its implicit 'value', ceases.

(ii) Due to Scotland having had a "theoretical surplus" since 1980 and so has not accumulated debt since that time

One of the options outlined in the Scottish Government's White Paper uses historic official GERS-based[4] figures to derive cumulative fiscal balances over the period 1980 to 2011, for both Scotland and the UK. This results in Scotland having 5.1% of the UK total, as opposed to its 8.35% population share[5].

Whilst calculating Scotland's debt obligations on this basis in future negotiations may be justified, one challengeable line would be, why begin in 1980; the year when North Sea tax revenues started to accrue to the UK and substantially boosted Scotland's fiscal balance?

Scotland's onshore (non-oil) fiscal balance is known to have been worse, in relative terms, than that of the UK back to 1980 and it would seem reasonable to argue that this would have been the case for some time earlier than that date too[6]. But how far should, and could, we go in making this calculation? It would be logical to calculate the net fiscal balance position, relative to the UK, back to 1707, but data that far back does not exist.

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[3] This point is discussed further in a recent paper by Armstrong & Ebell, 'Assets and Liabilities and Scottish Independence', 2014, NIESR Discussion Paper No. 426.

[4] Government Expenditure and Revenue for Scotland

[5] This calculation is questioned by Jim and Margaret Cuthbert in a paper for the Jimmy Reid Foundation, 'Issues surrounding the sharing of UK debt post-independence'. The Cuthberts' point out that if the debt servicing payments associated with the UK fiscal balance were removed, as they would not have arisen in Scotland post-1980, then the share would be much lower. Indeed, if the early 80s Scottish fiscal surpluses had been invested then a significant net asset position could have emerged. While such a theoretical outcome is possible, as the Scottish Government has not adopted this particular methodology in the White Paper, we have excluded the notion of a 'surplus' being brought into the negotiations.

[6] This assumption is based on the fact that the Barnett formula provides Scotland with a higher per capita grant allocation reflecting its historic assumed greater fiscal needs, relative to the UK.

Initiating the calculation in 1980 seems to be one of many potential starting points for such a calculation. Adding in the challenge of determining Scotland's share of the total debt arising from any such chosen start date means a wide array of different outcomes is highly plausible.

Finally, we are unaware of any historical disentanglement of the accumulation of national debt in the circumstances surrounding the break-up of other nations. In particular with respect to the Soviet Union, Yugoslavia or Czechoslovakia in recent times, or to Ireland, Singapore or Bangladesh, earlier in the twentieth century.

(iii) As part of a wider set of negotiations post a YES vote

Currency and debt are only two of a much larger number of areas where negotiation will be needed in the post-referendum period. The future of Faslane has already been identified as one. Who covers the decommissioning cost of nuclear power stations and North Sea operations are two others.

International experience on such matters suggests that each case is unique. For example, in Yugoslavia, debt issues were eventually decided by reference to IMF criteria. However, in the Soviet Union, the final agreement involved breakaway states being absolved from all debt, with Russia accepting such liabilities. In return, all other states accepted that Russia should take over from the Soviet Union with regards to its position at the United Nations and in its ownership of other territories around the world[7].

In a recent, unattributed quote, a UK coalition Minister stated that "There would be a highly complex set of negotiations after a Yes vote, with many moving pieces. The UK wants to keep Trident nuclear weapons at Faslane and the Scottish Government wants a currency union: you can see the outlines of a deal." This highlights the potential for a wide variety of negotiated settlements, covering debt, currency and other issues.

Summary

If, ultimately, argument (i) is pursued by the Scottish Government then the division of UK debt is likely to be acrimonious. Argument (ii) also seems likely to be disputed by the UK Government and therefore prove acrimonious. Argument (iii) is more likely to involve a mutually agreed, non-acrimonious, settlement.

This is an important point, as unilaterally walking away from part of the UK's debt is likely to lead to concerns over future behaviour from the markets, ratings agencies and the EU.

Just how much debt Scotland will be expected to support will depend on the Scottish Government's negotiation stance and tactics. However, it is difficult at present to predict which line(s) of argument the Scottish Government would concentrate on and how successful they might then be.

[7] See Chapter 11 of 'Scottish Independence, a Practical Guide', Murkens, Jones & Keating, 2002, for further discussion of debt sharing examples.

Implications for Scotland

In the event that part of such a negotiation involved Scotland having zero debt, the major implications for Scotland would cover a number of areas.

Assets and liabilities

If Scotland were to assume none of the UK's existing debt liabilities, then what might be the knock on impacts with regards to negotiations over its share of:

- UK assets outwith Scotland including, for example, assets in overseas territories (such as embassies but also the protectorates themselves), gold reserves, etc., and;
- liabilities within its borders e.g., future nuclear power station and North Sea decommissioning costs?

While Scotland's share of the associated running costs of many of the assets are included in the GERS figures, extra costs, for both Scotland and the UK, seem likely due to the loss of some economies of scale.

It is currently difficult to calculate what the net outcome of such a process of division on Scotland's asset and liability positions would be. In particular, the division of such assets and liabilities is likely to be affected by whether the debt negotiations are conducted cordially or otherwise.

The information needed to aid the referendum debate on this issue, by providing greater clarity, is unlikely to become available until after a majority YES vote has been delivered.

Debt and fiscal balance positions - Scotland

Starting with a zero historic debt position will change Scotland's fiscal position on day one of independence. At present, GERS uses a population share to apportion UK debt servicing costs to Scotland (i.e. 8.35%). By 2016-17 this is set to reach £5.5 billion, rising to £6.3 billion by 2018-19.

Table 1[8] shows the impact of an opening zero historic debt obligation on Scotland's absolute and relative (to the UK) fiscal position from the point of independence, assumed to be 2016-17, to 2018-19.

Table 1 assumes that Scotland receives its geographic (around 84-88%) share of North Sea tax revenues, and that these revenues are in line with the latest forecasts from the OBR in March 2014. Based on these assumptions, then, under independence:

- Scotland would have an absolute fiscal position that was much closer to balance initially and, by 2018-19, would be in surplus;

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[8] Table 1 also assumes the OBR's estimates for future North Sea tax revenues.

- Scotland's fiscal balance would be marginally better than the UK's over the period to 2018-19.

Table 1: Total Net Fiscal Balance, Scotland and the UK, 2013-14 to 2018-19

	2013-14 estimate	***2014-15 forecast***	***2015-16 forecast***	***2016-17 forecast***	***2017-18 forecast***	***2018-19 forecast***
£ billion (cash terms)						
Scotland	-13.0	*-12.9*	*-11.3*	*-9.4*	*-7.0*	*-5.3*
- excluding historic debt servicing				*-3.9*	*-1.0*	*1.0*
Total UK	-108	*-96*	*-75*	*-44*	*-17*	*+5*
£ per head (cash terms)						
Scotland	-2,430	*-2,420*	*-2,110*	*-1,740*	*-1,290*	*-980*
- excluding historic debt servicing				*-720*	*-180*	*190*
Total UK	-1,680	*-1,480*	*-1,160*	*-680*	*-250*	*70*
Scotland minus UK	-750	*-940*	*-950*	*-1,060*	*-1,040*	*-1,050*
- excluding historic debt servicing				*-40*	*70*	*120*
Cumulative difference (£billion)	-4.0	*-5.0*	*-5.1*	*-5.7*	*-5.6*	*-5.7*
- excluding historic debt servicing				*-0.2*	*0.4*	*0.6*

Source: OBR EFO March 2014, CPPR calculations

Clearly if Scotland assumed some of the debt, but less than its population share, then the position would improve by less, depending on the final agreed share.

It is worth noting that the £5.5 billion improvement in Scotland's fiscal balance by 2016-17 would be twice as much as the contribution from North Sea tax revenues in that year (£2.75 billion using a geographic share of OBR's latest forecast). This highlights the potential importance to Scotland's initial, and on-going, fiscal position that Scotland's inherited debt level would have[9].

It might also be argued that such a zero debt and debt servicing position would then accelerate the potential for Scotland to establish an Oil/Savings Fund for financial stability purposes and to share with future generations. This fiscal position could then be further enhanced if reductions on spending on what are currently reserved areas, such as Defence and International Aid, were also achieved.

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[9] Over the longer term, Scotland's debt servicing profile will be affected both by the composition and vintage of the debt as well as to the quantum it inherits. For a more detailed assessment of this important issue see Armstrong & Ebell, 2014.

However, this apparently very positive picture is clouded by a number of uncertainties. Principal amongst these is what credit rating would be attached to the issuance of any future Scottish debt. Such a rating will also be essential to the wider Scottish economy. Even with no historic debt obligations (and before any of the White Paper spending and cost saving measures are factored into the analysis), the Scottish Government would still need to borrow, if only to smooth within year revenue and expenditure mismatches[10].

The Scottish Government would also want to build up a credit record to facilitate access to borrowing as and when circumstances arose.

It would also be essential for the Scottish Government to borrow so that Scottish residents (corporates and individuals) could have ready access to private finance. This would inaugurate the Scottish sovereign rate of interest that is necessary for establishing a rate of interest for Scotland's commercial and individual borrowers.

Scotland's local authorities will also need access to debt irrespective of the Scottish Government's debt position as they currently borrow for a variety of purposes. For example, between 2008-09 and 2012-13 Scotland's local authorities borrowed £5.8 billion to fund their capital expenditure commitments (roughly £1.2 billion per annum) and, as at 31st March 2013, collectively they had a total loan fund liability of £12.77 billion[11].

So what might an independent Scotland's cost of finance be?

This again is difficult to judge. On the positive side, Scotland could have a very low debt to GDP ratio, one of a number of key determinants that underpin such credit ratings. On the other hand, Scotland would have no track record in, and reputation for, managing the full array of fiscal powers.

In addition, whilst the Scottish Government may negotiate in good faith a zero share of historic debt, this position may also arise following an acrimonious dispute with the rest of the UK. The latter outcome may then trigger the application of a punitive rate of interest, which would have a detrimental impact on Scotland's businesses, local authorities and borrowers in general.

Even assuming Scotland runs a budget surplus and retains no historic debt obligations, the financial markets will still need to understand how Scotland intends to manage its public finances. This applies both within any agreed currency union and with a separate Scottish currency. The markets will also require the development of a set of fiscal rules (ie, its debt to GDP target; its projected annual fiscal balance; its reserves policy, etc), and clarity around the currency arrangements that will be in place. So, if a zero debt option and a new currency

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[10] For example, the Norwegian Government runs a large annual surplus but still has general government debt levels equivalent to around 34% of its GDP in 2011 (see OECD Factbook 2013).

[11] See Scottish Government, Scottish Local Government Financial Statistics 2012-13. In seeking to reduce the Scottish share of UK debt to zero could also have the added benefit of fundamentally changing Scotland's local authority finances. The issue of local government borrowing in an independent Scotland is a significant one to which we will return.

arrangement turns out to be Plan B (or is part of Plan B), then extensive, credible, details on these critical technical issues would also need to be provided.

Debt and fiscal balance positions - RoUK

As a consequence of Scotland assuming none of the UK's debt, the UK would then have to meet its full debt obligations with a lower level of GDP. This would result in its debt to GDP ratio rising, something the UK coalition Government has been seeking to reverse with their fiscal austerity measures.

Such an obligation would add 8-9% to the UK's debt servicing costs. However, this amounts to a very small increase in UK expenditure (of less than one third of one percentage point as a share of GDP). How the markets react to this outcome is uncertain. The most recent statement from ratings agency Fitch[12], highlights potential negative UK effects from independence, in particular to its public debt ratio and a knock on impact in delaying any upgrade to 'AAA'. Whilst Fitch does not quantify this effect, overall they describe the additional risks to the UK as likely to be 'moderate'.

Scottish Government's currency option preferences

The Scottish Government's best scenario position would appear to be to negotiate a shared currency union with the UK along with a low, or zero, share of debt. Whether it can achieve such a favourable scenario remains an unknown until after the referendum.

At present its negotiating position, as suggested by the White Paper, is for a shared currency union and a debt share somewhere between its population share and a lower share based on a historical calculation going back to 1980 (ie, in line with option (ii) outlined earlier).

Despite the potential positive implications of a zero opening debt scenario, the Scottish Government has so far not used this option as a potential trade-off option in any wider negotiations but instead as a threat, in the scenario where the RoUK refuses to allow a formal currency union.

Such a bargaining position implies that the Scottish Government believes the long term negative consequences of a separate Scottish currency (or pegged to sterling without an official monetary and currency union) significantly outweigh the short term potential benefits of starting off with no debt and a near balanced budget (prior to factoring in any referendum spending and tax pledges).

There are arguments for and against Scotland having its own currency post-independence (for example, see the Fiscal Commission and Ronald MacDonald's evidence to the Scottish Parliament's Finance Committee). There are also clear benefits from starting off with a lower, or zero, debt position. At present the negotiations over what might suit Scotland best have been undertaken as a subset of the wider negotiations that would, in all likelihood, take place. This makes it very difficult to assess the relative costs and benefits of various debt

[12] Fitch Special Report, 2014, 'UK: Rating Implications of Scottish Independence'

obligations that are wrapped up in the costs and benefits of other negotiated positions in the referendum debate.

It also means that we have the rather unrealistic current stand-off between the Scottish and UK Government's over debt and a shared currency union. The reality remains that these wider negotiations could result in Scotland receiving its population share of debt, as happened in most past examples of nations splitting up, or it could end up with none, if the RoUK decides that there are wider, largely international and defence-related, strategic priorities that mean such a compromise is worthwhile.

The Fiscal Commissions remit does not extend beyond the realm of economic and fiscal implications of independence and so will not encompass the implications of wider points of negotiation, such as in relation to Faslane or the UK's overseas territories. Nevertheless, a broader consideration of the relative merits of the different currency options available with respect to Scotland's debt and fiscal balance positions seems overdue.

Conclusions

The issue of Scotland's inherited debt at the point of independence is an important one, both in terms of Scotland's future fiscal position and of its need to borrow. This is especially so given the poor prospects for Scotland's fiscal balance, when based on the latest OBR forecasts (see CPPR's most recent paper for more detail on this).

If a low, or zero, share of UK debt can be achieved, whether through negotiation or otherwise, it could substantially improve Scotland's fiscal balance and so strengthen its longer term fiscal prospects.

As the Fiscal Commission deliberates on the other currency choices, then historic debt variants should be factored into their analysis.

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