Scotland's economy: current situation and issues related to independence

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Authors: Tim Jarrett and Dominic Webb
Section Economic Policy and Statistics Section

This note sets out the recent economic performance of Scotland, in particular its relationship with the rest of the UK's economy, in terms of its growth, economic sectors, labour market, and fiscal position.

If Scotland were to become independent, there would be a number of economic questions that would arise including:

- The division of the UK continental shelf (oil and gas reserves);
- its currency;
- Scotland's share of UK debt.

These are discussed in the final section of this note.

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1 Introduction

This note considers the current state of the Scottish economy, and speculates on the possible economic implications of a vote in favour Scottish independence. Such analysis is difficult because of a number of uncertainties including:

- timing – any independence settlement might not be implemented for some time after the referendum. As such, there is considerable uncertainty about how the Scottish economy might look at that time, as well as the state of the UK and global economies.
- independence settlement terms – this would be a political decision between Scotland and the rest of the UK, determining the allocation of the UK's debt, and also the division of the UK continental shelf in respect of oil and gas reserves;
- the policy of the Government of an independent Scotland – economic, financial and other policies such as immigration would have a significant bearing on the prospects for the economy of an independent Scotland;
- the benefits and costs of independence are unlikely to be constant, but rather will ebb and flow over time.

2 The Scotland Act 2012

The Scotland Act 2012 increases the financial powers of the Scottish Parliament. By the time its provisions are fully implemented, in April 2016, the Scottish Parliament will raise around 30% of its budget compared with around 15% now. The main financial provisions include:

- A new Scottish rate of income tax which will replace part of UK income tax
- Devolution of stamp duty and landfill tax
- New borrowing powers, subject to certain limits
- A Scottish cash reserve.

3 Economy

3.1 Fiscal position – is Scotland "subsidised"?

Expenditure per head

In 2010/11 public spending per head in Scotland was around £1,500 (18%) higher than in England, according to figures published by the Treasury. Spending per head in Scotland was around the same as that in London but lower than in Northern Ireland.

Public expenditure by country and region, per head (£ per head) (a)

	2009-10	2010-11	2010-11 Index UK = 100
North East	9,433	9,501	107
North West	9,229	9,386	106
Yorkshire and the Humber	8,449	8,512	96
East Midlands	7,917	8,098	91
West Midlands	8,579	8,679	98
East	7,647	7,834	88
London	10,183	10,198	115
South East	7,481	7,529	85
South West	7,942	8,096	91
England	8,531	8,634	97
Scotland	9,940	10,165	114
Wales	9,709	9,947	112
Northern Ireland	10,564	10,668	120
UK identifiable expenditure	8,766	8,884	100

Sources: HM Treasury, *Public Expenditure Statistical Analyses,* ONS, *Regional GVA*, Library calculations

Notes: (a) Identifiable public expenditure on services

The figures for Scotland (and the other countries and regions) cover all spending which can be identified as benefiting residents of that area. For Scotland, this means the data cover spending by the Scottish Government but also spending in Scotland carried out by UK government departments. An example of the latter would be benefit spending which is carried out by the Department for Work and Pensions throughout the whole of Great Britain.

The data covers expenditure allocated on the basis of the region that benefited from the expenditure or whom the expenditure was for, which covers around 83% of total public expenditure. This is known as "identifiable expenditure". Some expenditure, such as most defence spending, is regarded as benefiting the UK as a whole and therefore is not attributed to a particular region. The Library Standard Note, *Public expenditure by country and region* (SN04033) sets out public expenditure in Scotland, and the other countries of the United Kingdom in detail.

The Scottish Government also publishes its own estimates of public spending per capita.[1] These show public spending per head of £11,785 for Scotland and £10,663 for the UK. On these figures, Scotland's spending per head is 10.5% higher than for the UK as a whole, a slightly lower differential than the 14.4% on Treasury figures given the table above.

1 Scottish Government, *Government Expenditure and Revenue Scotland 2010/11*, 7 March 2012, Table 5.6, p40

The allocation of public spending to the devolved administrations is determined by the population-based Barnett formula.[2] The formula has been criticised for being unrelated to need.[3]

A number of arguments have been put forward as to why Scotland, Wales and Northern Ireland might need higher levels of public spending per head than England. For example, the population is more sparsely distributed in these countries and this makes provision of a standard level of service more expensive. In the past, commentators have also referred to higher morbidity rates and poverty in Scotland. Others point out that Scotland's per capita income is greater than a number of English regions which receive less public money.

Total tax revenues and public expenditure

The Scottish Government has estimated the tax receipts of Scotland for 2010/11. Excluding revenues from North Sea oil production, Scotland had revenue of £45.2 billion (8.3% of the UK total)

The allocation of North Sea oil and gas revenues has a significant impact. If Scotland is allocated a share based on its share of the UK population (8.4%), total revenue increases from £45.2 billion to £45.9 billion. The Scottish Government also presents an estimate based on an "illustrative geographical share" where Scotland receives around 85-95% of North Sea revenue. Under this approach, revenue increases to £53.1 billion, or 9.6% of UK revenues.[4]

The Scottish Government estimates that total public spending in Scotland in 2010/11 was £61.6 billion. Using this figure, together with the various estimates of revenue, allows estimates of Scotland's net fiscal position to be calculated. These are shown in the table below. Scotland has a fiscal deficit on all three approaches to allocating North Sea revenue. The deficit is greatest if no oil revenue is allocated to Scotland. Under this scenario, the deficit is £18.6 billion or 15.6% of GDP. If the geographical share of revenue is allocated the deficit falls to £10.7 billion (or 7.4% of GDP). It is important to remember that the UK as a whole had a fiscal deficit in 2010/11 of 9.5% of GDP.

Scottish Government estimates of Scotland's net fiscal balance, 2010/11, £ billion

	No North Sea revenue	per capita share of North Sea revenue	Geographical share (85-95%) of North Sea revenue
Revenue	45.2	45.9	53.1
Expenditure	63.8	63.8	63.8
Net fiscal balance	-18.6	-17.9	-10.7
Net fiscal balance, % of GDP	-15.6	-14.7	-7.4

Source: Scottish Government, Government Expenditure and Revenue Scotland 2010-11, Tables 2.1 and 2.2a-c

Oxford Economics have calculated fiscal balances (the difference between revenue and spending) for the countries and regions of the UK. In this calculation, revenue from the North

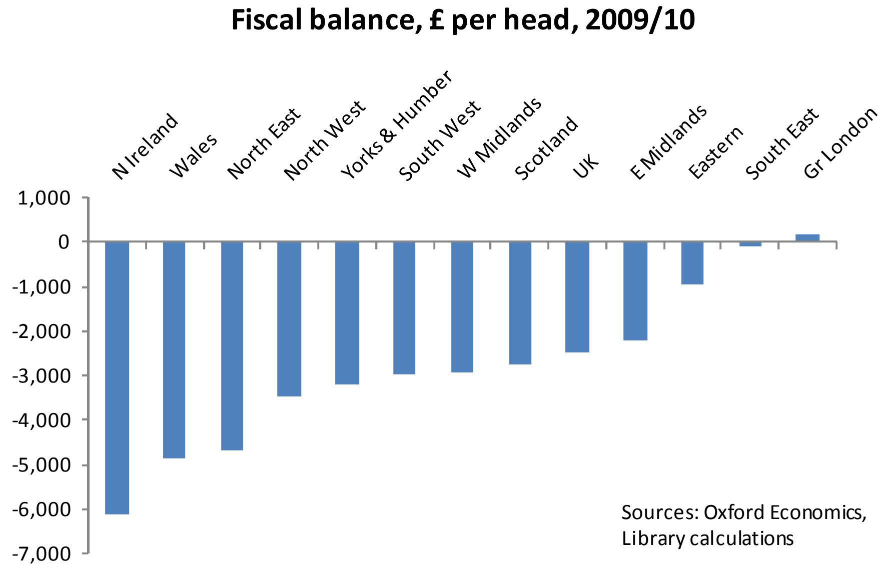
2 There is more information on the Barnett Formula in House of Commons Library Research Paper, *The Barnett Formula*, RP07/91, December 2007

3 For example, see House of Lords Select Committee on the Barnett Formula, *The Barnett Formula*, 1st report 2008/09, 17 July 2009, p7

4 Scottish Government, *Government Expenditure and Revenue Scotland 2010/11*, 7 March 2012, p5

Sea is allocated to Scotland. The fiscal balances are shown in the chart below on a per head basis.

Scotland's deficit was around £2,750 per head in 2009/10 compared to £2,500 for the UK as a whole. Scotland's deficit per head is lower than those of Wales and Northern Ireland and five of the English regions. Four English regions have a lower deficit. Of these, only one (London), had a surplus in 2009/10.



3.2 Economic output

Contribution to UK economy

The table below highlights that Scotland's economy contributed 8% to the UK economy in 2010 using the gross value added (GVA) measure.

Gross Value Added (GVA)

	Contribution to UK economy
Scotland	8%
England	86%
Wales	4%
Northern Ireland	2%

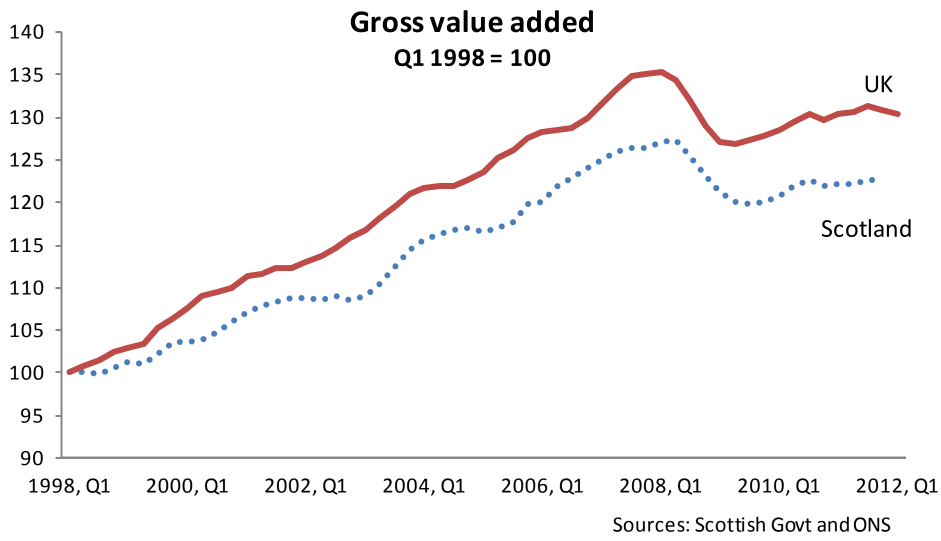
Source: ONS, *NUTS 1 Headline workplace based GVA at current basic prices*, Table 1.1, Library calculations

Note: Excludes extra regio and statistical discrepancy

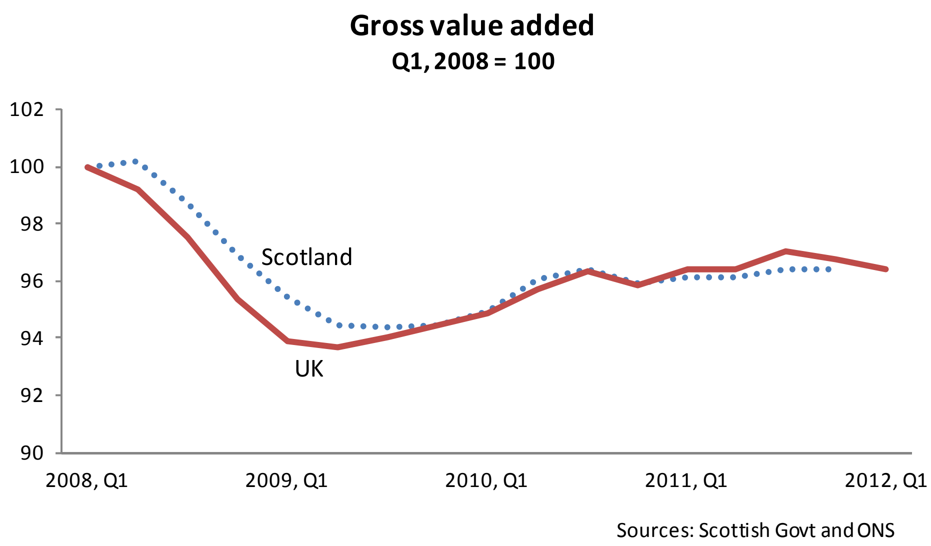
Scotland's GVA per head was approximately £20,200 in 2010, very similar to the UK average of £20,500. GVA per head in Scotland was higher than all UK regions except for London and the South East. For further information on regional GVA, see the Library Standard Note SN5795.

Growth

Economic growth in Scotland and the UK as a whole since 1998 is shown in the chart below. Over the period as a whole, the UK economy has grown by 30% compared with 22.5% for Scotland.



Both the UK and Scottish economies have been affected by the financial crisis. The chart below shows that the recession has been slightly less deep in Scotland than in the UK as a whole. The level of economic output remains 3-4% below its pre-recession peak in both Scotland and the UK.



Sectoral breakdown

Analysis of the contributions of different sectors to growth in 2009 (the latest year for which data is available) compared to 2008, when Scotland's economy contracted by 2.4% (compared to -3.4% for the rest of the UK) shows that financial and insurance activities contributed the most to growth, at 0.74 percentage points. Construction, and real estate activities both took over 1 percentage point off the rate of economic growth in Scotland.

Contribution to Scottish Gross Value Added (GVA) growth 2009 (percentage points)

Top 5		Bottom 5	
Financial and insurance activities	0.71	Real estate activities	-1.20
Mining and quarrying	0.39	Construction	-1.09
Electricity, gas, steam and air-conditioning supply	0.36	Professional, scientific and technical activities	-0.31
Human health and social work activities	0.35	Manufacturing	-0.28
Other service activities	0.03	Wholesale and retail trade,	-0.25

Source: ONS, NUTS1 Regional GVA 1997-2010 Table 1.3 and Library calculations

Manufacturing accounted for 11.4% of the Scottish economy in 2009 compared with 10.2% for the rest of the UK. [5] Significant sectoral differences between the two economies include mining and quarrying which contribute 3.3% of Scotland's economy (0.3% for the rest of the UK economy); this partly reflects the contribution of hydrocarbon exploration and production, much of which is in Scottish waters. Information and communication contributes 3.8% of the Scottish economy, compared to 6.5% of the rest of the UK economy.

These two differences help to account for the fact that production (which includes manufacturing) contributes more to the economy in Scotland than in rest of the UK (19.0% vs 13.2%), while correspondingly service industries contribute less (72.2% in Scotland, 78.7% in the rest of the UK).[6]

However, the composition of the Scottish economy has changed since 1997: the dominance of the manufacturing sector has been sharply reduced: manufacturing growth was negative in every year during 1997 to 2009, except 2005 to 2007.

Two sectors, the human health and social work activities sector, and the financial and insurance activities sectors, have both grown markedly since 1997 to stand as the second and fourth largest sectors in 2009.

[5] The sectors are: agriculture, forestry and fishing; mining and quarrying; manufacturing; electricity, gas, steam and air-conditioning supply; water supply – sewerage, waste management; construction; wholesale and retail trade, repair of motor vehicles; transportation and storage; accommodation and food service activities; information and communication; financial and insurance activities; real estate activities; professional, scientific and technical activities; administrative and support service activities; public administration and defence – compulsory social security; education; human health and social work activities; arts, entertainment and recreation; other service activities; activities of households.

[6] The figures for production and service industries do not sum to 100%, as they exclude the separate categories of agriculture, forestry and fishing, construction and the activities of households.

Largest sectors of the Scottish economy

	Scotland		rest of UK
	1997	2009	2009
Manufacturing	19.0%	11.4%	10.2%
Human health and social work activities	7.6%	10.1%	7.9%
Wholesale and retail trade, repair of motor vehicles	10.2%	9.7%	11.3%
Financial and insurance activities	5.4%	9.0%	10.4%
Construction	7.0%	7.8%	7.0%

Source: ONS, NUTS1 Regional GVA 1997-2010 Table 1.3 and Library calculations

3.3 Corporate statistics

Around one-fifth of private sector economic activity in Scotland is accounted for by companies owned elsewhere in the UK. The *Scottish Business Survey* (SBS) has some data on company ownership:[7]

- companies owned in the rest of the UK accounted for 19% of total private sector employment and 12% of manufacturing employment in Scotland in 2009;
- the proportions are larger on a gross value added (GVA) basis – companies owned in the rest of the UK accounted for 23% of total private sector GVA and 22% of manufacturing GVA.

In addition, large companies (i.e. with 250 or more staff) based elsewhere in the UK employ roughly the same number of people in Scotland as large companies based in Scotland (with foreign companies also providing a significant contribution).

This data is from the Inter-Departmental Business Register cross-referenced with Dun & Bradstreet ownership data and published in the Scottish Government's *Scottish Corporate Sector Statistics 2011*. These figures only cover employment in enterprises registered for PAYE or VAT, and so exclude smaller firms, which are more likely to have their employees in the same country in which they are headquartered. The figures also exclude public sector employment.

The table below shows Scottish employment by employees size band and country of ownership in 2011:

[7] This data is not available for England only

Scottish employment by enterprise employees size band and country of ownership
March 2011

	Employment				% total			
Employees size band	Scotland	UK (excl Scotland)	Abroad	**Total**	Scotland	UK (excl Scotland)	Abroad	**Total**
0-49	611,320	4,590	7,080	622,980	98%	1%	1%	100%
50-249	210,410	14,780	27,580	252,770	83%	6%	11%	100%
250+	327,460	332,170	246,190	905,810	36%	37%	27%	100%
Total	**1,149,180**	**351,530**	**280,850**	**1,781,560**	**65%**	**20%**	**16%**	**100%**

Source: Scottish Government, *Scottish Corporate Sector Statistics 2011* , table 3

Unsurprisingly, most of small company employment in Scotland is accounted for by Scottish companies.

There were 53 Scottish-based companies listed on the London Stock Exchange at the end of 2011, with a combined market value of £54 billion; the largest company was SSE plc (an energy company) with a market value of £12 billion.

3.4 Foreign Direct Investment

In terms of Foreign Direct Investment (FDI), while capital flows are not available in official statistics, the National Institute of Economic and Social Research (NIESR) stated that "the large number of Scottish firms which have been taken over by companies outside of Scotland suggests considerable direct investment inflows. Of course, these figures do not tell us about Scottish ownership of enterprises in the rest of the UK or overseas.[8]

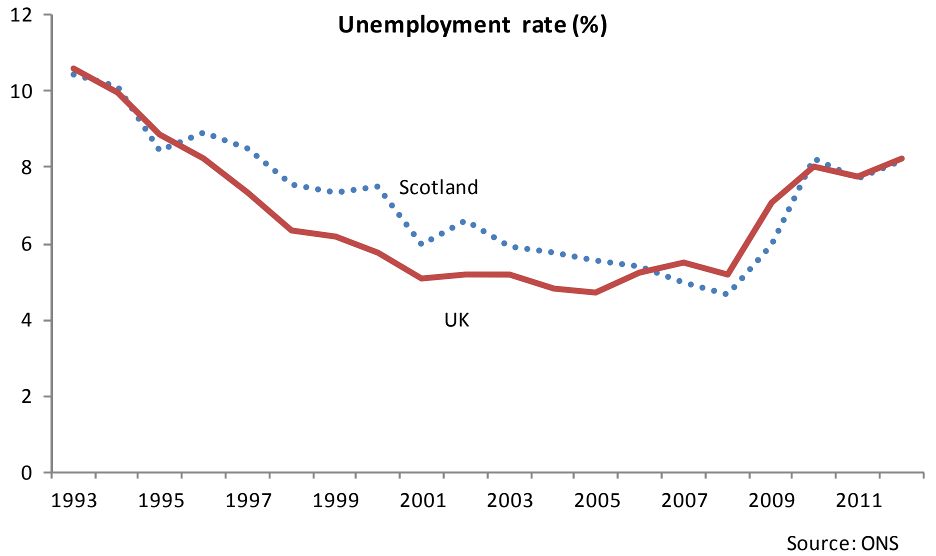
According to the Ernst & Young "European Investment Monitor", in 2009/10 there were 43 inward investment projects in Scotland, the highest country of the UK after England, and better than all the English regions except the South-East (328) and the West Midlands (47).

3.5 Unemployment

Unemployment is currently 8.2% in both Scotland and the UK as a whole.[9] The trends since 1993 are shown in the chart below. Unemployment was higher in Scotland than the UK for around 10 years from 1995. Scottish unemployment fell below the UK level between 2006 and 2009.

8 National Institute for Economic and Social Research, *National Institute Economic Review*, Number 219, January 2012, p F5 [subscription required]

9 February – April 2012



4 Future issues

4.1 The small and open nature of the Scottish economy

In its report, *Commentary: Scotland's currency and fiscal choices*, the National Institute of Economic and Social Research stated that "in economic terms, … Scotland is a small and very open economy". In reaching this assessment, it was noted that:

> Combining official and the Scottish Government's experimental data series, the total value of exports and imports of goods and services, or all goods and services traded across Scotland's borders, is broadly the same as the value of output consumed within Scotland's borders.[10]

As a small and very open economy, Scotland would be particularly exposed to exogenous economic shocks i.e. shocks that are caused by factors outside of Scotland's control. These shocks could be positive or negative in nature; for example, given the sizeable contribution of oil and gas to the economy (and by association the fiscal position), one such shock could be a significant move in global energy prices.

The report also found that Scotland was "more integrated with the rest of the UK than with Europe or the rest of the world". In terms of the annual growth rate of real GVA, it noted that "the trends for Scotland, the UK and the Euro Area are all very similar", and added that "the composition of Scotland's industrial structure and annual rate of retail sales price inflation are more correlated with the UK than Europe. The co-movement of cycles suggests that shocks will have a symmetric effect in both countries".[11] This is perhaps unsurprising given that Scotland and the rest of the UK share a common economic policy.

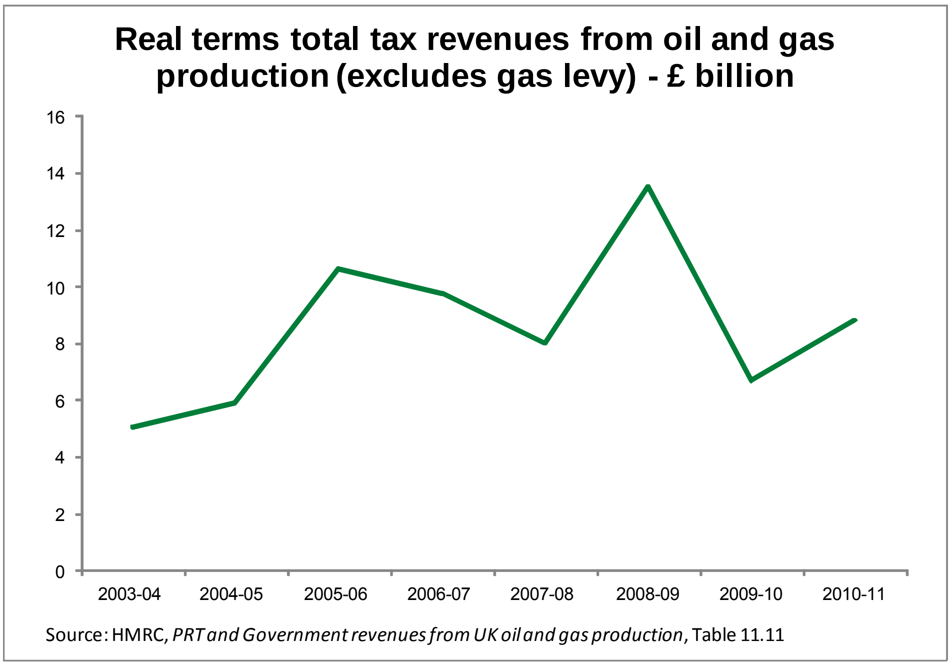
4.2 Oil production and tax revenues

Revenues to the UK Exchequer from hydrocarbons have been volatile over recent years, influenced by production levels and the oil price. In the 1998/99 financial year, when oil prices fell below $10/barrel, revenues were £2.5 billion, but in 2008/09, when the oil price

[10] National Institute for Economic and Social Research, *National Institute Economic Review*, Number 219, January 2012, p F5 [subscription required]

[11] As above, p F6

peaked at nearly $150/barrel, revenues were £12.9 billion.[12] The absolute peak in hydrocarbon-related revenues occurred in 1984/85 when, in real terms, a figure of £28.3 billion was achieved. Even in recent years, tax revenues from hydrocarbons have been volatile:



There are perhaps three key issues when considering the future contribution to tax revenues should Scotland become independent: the division of the UK Continental Shelf (UKCS), future production levels, and the price of oil.

In their 2008 paper, *The Hypothetical Scottish Shares of Revenues and Expenditures from the UK Continental Shelf 2000 – 2013*, Professor Alexander Kemp and Linda Stephen of Aberdeen University considered what they termed "the boundary issue". They noted that this issue had been subject to debate "over many years", and that "in practice this would be subject to negotiation between the relevant Governments".

They presented some possible solutions, and in so doing highlighted the complicated nature of determining the exact position of the Scottish boundary of the UKCS:

> There is some presumption that the line of equidistance should be employed to determine the boundary, and this was deployed in the negotiations between the UK Government and the other Governments which had Continental Shelves in the North Sea. But use of the line of equidistance has not been exclusively employed to determine boundaries, particularly after the ruling of the International Court in 1969 regarding the boundaries between West Germany, Denmark, and Belgium. A further legal feature is the line of jurisdiction in the North Sea for civil jurisdiction purposes [under the *Continental Shelf (Jurisdiction) Order 1968*, SI 1968 No. 892] established between Scotland and England in 1968 (latitude 55°50′N). Some legal opinion holds that this has set a precedent for the determination of the boundary for the division of the Continental Shelf, but this is open to dispute. In 1999 the median line principle was

[12] Scottish Government, *Government Expenditure & Revenue Scotland 2009-2010*, June 2011, Table 5.1

> employed to determine the boundary between Scotland and England for fisheries demarcation purposes [*Scottish Adjacent Water Boundaries Order 1999*].[13]

The Scottish Government have calculated that, in 2010/11, Scotland's share of North Sea oil revenues would be 91% if the oil was apportioned on a geographical basis (based on the median line approach),[14] but only 8% if revenues are apportioned on a per capita basis.[15]

It is widely considered that North Sea oil and gas production has peaked already. Kemp and Stephen found that the "hydrocarbon production will continue the fall in the period to 2013 (and beyond) and gross revenues are likely to follow this downward trend [in recent production]".[16]

The Office of Budget Responsibility's July 2011 Fiscal Sustainability Report says:

> UK oil and gas revenues are expected to fall from a peak of 0.9 per cent of GDP in 2011-12 to 0.6 per cent in 2015-16 and then to between 0.1 and 0.2 per cent of GDP from 2028 onwards. In these projections many fields would cease production in the 2020s. At this point companies would receive tax relief for decommissioning expenditure. This is the main reason why PRT [Petroleum Revenue Tax], which only applies to older fields, turns negative at the end of that decade.[17]

A third unknown is the oil price – this has varied in recent years from a low of nearly $9/barrel in November 1998 to a peak of almost $150 in July 2008.[18]

The price of oil would affect both the value of oil extracted, and the amount of tax derived from that. It would also affect production – deep water oil extraction is considerably more expensive than land drilling; a low oil price would mean that it would not be economical to extract hydrocarbons, and could reduce exploration. Conversely, a continuing strong oil price would encourage production and further exploration.

In terms of tax revenues derived from oil production, Kemp and Stephen stated:

> It should be stressed that the projections of tax revenues are subject to much uncertainty. Thus oil prices have been very volatile and this should remain the case over the next few years. Further, there has been dramatic cost escalation in all activities in the UKCS, and a continuation of this will adversely affect taxable income. Production has also fallen at a considerably faster pace than forecast only a few years ago and predicting future production is also subject to much uncertainty. There are thus substantial downside risks to the projections made as well as some upside potential from still higher oil prices. The former risks are probably the stronger ones.[19]

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13 Kemp, Professor Alexander G. and Stephen, Linda, *The Hypothetical Scottish Shares of Revenues and Expenditures from the UK Continental Shelf 2000 – 2013*, June 2008, p4

14 It should be noted that the percentage figure for the geographic basis varies year-on-year (depending upon where on the UKCS the hydrocarbons were recovered) – the figure was 84% in 2006-07, but 95% in 2007-08 as all but 5% of hydrocarbons recovered were in the Scottish area of the UKCS as defined by the median line approach.

15 Scottish Government, *Government Expenditure & Revenue Scotland 2010-2011*, March 2012, Table 4.4, p33

16 Kemp, Professor Alexander G. and Stephen, Linda, *The Hypothetical Scottish Shares of Revenues and Expenditures from the UK Continental Shelf 2000 – 2013*, June 2008, p4, p35

17 Office for Budget Responsibility, *Fiscal Sustainability Report,* p104, para 4.57, July 2011

18 US Energy Information Administration, *Europe Brent Spot Price FOB (Dollars per Barrel)*

19 Kemp, Professor Alexander G. and Stephen, Linda, *The Hypothetical Scottish Shares of Revenues and Expenditures from the UK Continental Shelf 2000 – 2013*, June 2008, p4, p35

4.3 Debt transfer from the rest of the UK

If Scotland was to become independent, the question would arise as to how much of the UK's debt burden it should assume.

NIESR have calculated that because Scotland's per capita gross value added is 98.7 per cent of the UK, "there is only marginal difference between apportioning debt on a per capita or pro rata basis".

Forecasting to 2014, by making an assumption about nominal GDP growth (which it assumes will grow by 15 per cent) and using the official net debt projections between 2009/10 and 2014, NIESR has calculated the UK's public debt in 2014. Taking Scotland's share of it, NIESR calculates that it will be either 80% or 70% of Scotland's GDP – the difference is explained by how the allocation of oil revenues is resolved (the higher figure for assuming oil reserves are allocated on a per capita basis, the lower assuming oil is assigned on a geographical basis).

The David Hume Institute published a paper in March 2012 took various approach to calculating Scotland's share of current UK net debt, which at the time of their calculations (January 2012) stood at 64.2%. Their research found that:

- Scottish GDP including a geographical share of oil would be £159bn resulting in a net debt/GDP ratio of 52.2%.
- Taking onshore GDP (without North Sea oil) indicates a net debt/GDP ratio of 66%.
- Calculating the ratio using Scottish GDP including a population share of oil GDP results in a net debt/GDP figure of 64.3%.[20]

However, the paper concluded that "we have declined to create a final total of possible inherited debt. There are simply too many uncertainties and too many scenarios – most of which could change significantly by the time of the referendum – to provide sensibly any single figure that would be 'Scotland's debt total'". The paper added "the complexities of the situation will be fertile ground for political and economic debate going forward".[21]

One such complexity was the fact that the UK Government owns almost all of RBS and a very significant proportion of Lloyds Banking Group (LBG), both of which have their corporate headquarters in Scotland. The headline Office for National Statistics (ONS) figures on public sector net debt exclude the temporary effects of the bank bailout – as the banks will eventually be sold back into the private sector, these give a better guide to the underlying state of the public finances.

However, the ONS also publishes figures *including* the temporary effects of the bank bailout. These show public sector debt as £2.2 trillion (around 145% of GDP) in 2011/12, up from £620 billion (43% of GDP) in 2007/08. These figures are rather misleading, however, as they count the liabilities of the public sector banks (including Lloyds and RBS) but *exclude* most of their assets.

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[20] David Hume Institute, *Issues Facing an Independent Scotland – Scotland's Share of UK Public Debt*, March 2012, p3

[21] David Hume Institute, *Issues Facing an Independent Scotland – Scotland's Share of UK Public Debt*, March 2012, p10

The David Hume Institute has analysed the Scottish Government's assessment of the UK government's financial sector interventions, which provides information on Scotland's share of the permanent effects of the interventions. According to the analysis, in the 2010/11 financial year Scotland received a population share of fees amounting to an income of £154 million. There were no capital or other outlays.[22]

4.4 Issuance of bonds and credit ratings

If Scotland became independent, it would have to establish a system of cash and debt management in order to manage its public finances. This would be necessary to fund any debt that the Scotland Government had, and also to finance the differences between tax receipts and expenditure during the financial year.

For both cash and debt instruments, a key consideration is the credit rating of the issuer. The rating provides a guide to how likely it is that a lender will receive both the interest and their money (the principal) back from the borrower on time. The risk of lending to a relatively good borrower is lower, and therefore the return (in this case the interest rate, or yield) demanded by the lender will also be lower (assuming all other conditions are the same).

In a working paper published in 2007, the European Central Bank studied the determinants of sovereign debt credit ratings using rating notations from the three main international rating agencies (Standard and Poor's, Moody's and Fitch Ratings) for the period 1995-2005, and noted that:

> The main finding is that GDP per capita, real GDP growth, government debt, government effectiveness ["high quality of public service delivery and competence of bureaucracy"], external debt and external reserves, sovereign default indicator as well as being a member of European Union, are the most important determinants of the sovereign debt ratings. We find that the government related variables have a stronger effect than found in existing literature.[23]

According to a *Financial Times* report in February 2012, the methodology of one ratings agency, Moody's Investor Services, "explicitly states that countries would be marked down if they did not have a long record", quoting that it states "immature economic and political institutions increase the risk of unpredictable behaviour in times of stress, inviting negative credit implications".

The Scotland Act 2012 allows Scottish Ministers to borrow from the National Loans Fund and commercial banks. The Act also contains a provision which would enable the UK Government to amend the borrowing arrangements to allow the issuing of bonds by the Scottish Government. The Treasury is currently consulting on the costs and benefits of granting this power to the Scottish Government.[24]

If that change was brought into effect, then Scotland might require a decision on its credit rating to be made – however, such a rating would not necessarily be the same rating that was assigned to an independent Scottish Government.

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[22] As above, pp9 and 10

[23] European Central Bank, *What "Hides" Behind Sovereign Debt Ratings?*, Working Paper Series No 711, January 2007, p5

[24] HM Treasury, *The Scotland Act 2012: a consultation on bond issuance by the Scottish Government*, June 2012

In the same report, the *Financial Times* stated that “the three leading credit rating agencies – Standard & Poor’s, Moody’s and Fitch – indicated an independent Scotland would not automatically inherit the UK’s top-notch rating [of AAA]. Scotland could expect to receive an investment grade rating, but some notches below triple A, one agency told the FT privately”. It added that “the agencies declined to comment publicly on the precise ratings Scotland could achieve because they do not undertake unsolicited ratings and the Scottish government has not yet sought a draft opinion”.

The Scottish Government, on the other hand, have highlighted the importance of Scotland’s asset base when it comes to determining its credit rating. The Cabinet Secretary for Finance, Employment and Sustainable Growth, John Swinney, said:

> Inaccurate arguments have also been used to claim that Scotland will not secure a triple A credit rating and will therefore need to more rapidly curtail public expenditure or raise taxes. But this undervalues the strength of Scotland’s asset base: remaining oil reserves with an estimated wholesale value of £1tn; more than £3bn of whisky exports; the oil and gas research and development skills vested in the north-east; our highly diversified financial services sector; and the untapped potential of our wind, wave and tidal power.[25]

The *Financial Times* also reported that Mr Swinney was “confident of a top rating because ‘it was difficult to deny the effectiveness and strength of the economy’”.[26]

4.5 Currency

An independent Scotland would need to make a decision on its currency. There are broadly three options:

a. adopt their own currency;

b. retain the pound sterling (either formally or informally);

c. adopt the euro.

Own currency

If Scotland was to adopt its own currency, a number of key issues would arise such as the level of the exchange to the pound sterling, and a foreign exchange policy would be need to be developed. A central bank would presumably need to be established, and foreign reserves would need to be accumulated.

A Scottish currency could be volatile against the pound sterling, and exporters and importers might face costs in order to insure against adverse currency movements. In order to address this, a currency policy to peg to the pound sterling could be adopted.

Pound sterling

John Swinney, MSP, the Finance Minster in the Scottish Government, has said that an independent Scotland would retain the pound. Speaking in June 2012, he said:

> Retaining the pound under independence is something that I believe is in the interests of Scotland, the rest of the UK and the stability of Sterling itself.

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25 “Scotland can go it alone and stay triple A”, *Financial Times*, 1 February 2012 [subscription required]

26 “Doubt cast on any future Scottish sovereign rating”, *Financial Times*, 5 February 2012 [subscription required]

> As an internationally tradable currency Sterling is as much Scotland's currency as it is the currency of England and Wales, and a formal monetary union is the clear way forward.
>
> Regardless of what may be said in the heat of constitutional debate it would simply not make sense for anyone to resist the creation of a formal Sterling zone and the mutual benefit it would bring.[27]

This option raises a number of issues, such as fiscal responsibility and the lender of last resort.[28]

It is important to distinguish between central banks acting as lender of last resort to financial institutions like Royal Bank of Scotland, and acting as lender of last resort to the government. Were the Bank of England to agree to act as lender of last resort to Scottish banks, it would be likely to require in return that they satisfy UK banking regulations; like other UK banks, they may also be required to implement the proposals of the Vickers' Commission.

Fiscal rules, however, would not follow (at least not logically follow) directly from the Bank of England assuming lender of last resort responsibility; rather, they might be imposed as part of the wider negotiation over the nature of Scotland's monetary union with the UK, and the role of the Bank of England.

This could well be the case if Scotland's monetary union with the UK is formalised, as it is in the eurozone, with the Bank of England continuing to form monetary policy for the whole UK (becoming, in the words of Brian Ashcroft, a "Bank of Sterling").

It should also be noted that, absent a formal monetary union, it would be difficult to 'stop' Scotland using sterling as a medium of exchange following independence. Montenegro uses the euro without being a member of the eurozone or the EU: it is thus not bound by EU fiscal rules, but equally its banks cannot borrow from the European Central Bank, nor can it influence eurozone monetary policy. The same is true of dollarized economies like El Salvador and Ecuador. In such a scenario, Scotland's monetary policy would be determined by the Bank of England which would only be considering the interests of the rest of the UK.

Euro

Adopting the euro would be predicated on Scotland joining the European Union (see Library Standard Note, *Scotland, independence and the EU*, SN/IA/6110). If so, membership of the European single currency would probably require Scotland to pass the convergence criteria (known as the Maastricht criteria), namely price stability, government budgetary position, exchange rate stability, and long-term interest rates.[29]

It should be noted that it is ultimately a matter for the Council of the European Union, composed of Heads of State or Government, to determine whether a country fulfils the conditions for membership of European economic and monetary union (EMU).However, given the recent crises in euro-zone member states (in particular Greece), a greater barrier to any consideration of joining EMU would be the prevailing stability of the single currency. Political and public appetite to join the single currency might be dampened in the light of recent events and longer-term uncertainties.

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27 John Swinney MSP, *Opportunities for Scotland's economy*, Speech 11 June 2012

28 For example, see "Economics emerges as central to Scotland's future", *Financial Times*, 12 January 2012 [subscription required]

29 For more detail, see: European Commission, *Glossary: Convergence criteria*, website [taken on 3 February 2012]