

## **What would the picture for the Scottish Government's finances be if Scotland votes yes? What if Scotland votes no?**

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The outlook for the public finances of an independent Scotland is a key battleground in the referendum debate. Why? Because the health of the government's finances determine how much can be spent on public services like schools, the NHS, and welfare and pensions. It is also key to understanding whether taxes can be cut or need to be increased to avoid the government borrowing unsustainably. So ultimately it affects how much money individuals and families will have in their pockets, and the quality and quantity of public services they can enjoy in the years ahead.

### **If Scotland votes No**

At the moment most tax paid by people and businesses in Scotland goes into one central pot controlled by the UK government in Westminster. The UK government is responsible for defence, foreign affairs and for paying benefits and state pensions to Scottish people. It also gives money as a block grant to the Scottish Government to pay for devolved services – it is then up to the Scottish Government to decide how to allocate this between services such as schools, hospitals, policing, transport etc. The size of this grant does not depend on how much tax revenue is raised in Scotland, but is based on historic spending in Scotland, adjusted each year so that changes in spending broadly match changes in government spending in England. In recent years the grant has been large enough to allow total government spending in Scotland to be around 11% higher per person than the UK average.

If Scotland votes No this would largely continue – for a few years at least. Some small taxes are due to be devolved to Scotland in April 2015, and the Scottish Government will gain more powers over the rate of income tax in Scotland a year later. This will mean some extra risk for the Scottish Government's budget – revenues from these taxes can be volatile – but also bigger incentives to grow the economy. Still, most taxes will go to Westminster and come back to Scotland in the form of a block grant. The Scottish Government's finances will still depend on the size of this grant.

Since 2010, the block grant has been cut by 8.8% after accounting for inflation. This is a result of the UK government's wider spending cuts designed to reduce the large budget deficit caused by the "Great Recession". Under current UK government plans, these spending cuts will continue until 2018–19 (by when the UK as a whole should be running a small budget surplus). This could mean that for the next five years cuts in the block grant could be even bigger than those made so far. The Labour Party says it would not cut quite so deeply, but would still likely be looking to make further cuts to government spending.

In the longer-term, the pro-Union parties have offered further devolution if Scotland votes No – for instance, further control of income tax policy.

### **If Scotland votes Yes**

Independence would mean the Scottish Government would have full control over taxes and spending. This would give additional freedoms, but also new responsibilities. In particular, an independent Scottish Government would bear all the risk of volatile tax revenues as the economy fluctuates. While it could borrow money in the short-term to make up for any deficit, in the longer-term it would need to ensure tax revenues were high enough to pay for spending to ensure that the budget was sustainable.

The Scottish Government's estimates show that in 2012–13, tax receipts (including oil and gas revenues) were £789 higher per person in Scotland than across the UK as a whole, but government spending was £1,256 higher per person. This means Scotland's notional budget deficit for that year was 8.3% of Scotland's GDP (national income), which was bigger than the deficit of 7.3% of GDP for the UK as a whole.

The past is not necessarily a good guide to the future though, and whether an independent Scotland's government finances would be stronger or weaker than those of the UK will depend on a number of factors:

- How much of the UK's national debt Scotland would inherit,
- How strong oil and gas revenues are in future,
- How well the broader economy of Scotland would perform.

Disagreements about these factors are what underlies the starkly different visions for the public finances of an independent Scotland outlined by the Yes and No campaigners.

### *What does the No side say?*

Better Together and the UK government argue that the government of an independent Scotland would face a worse financial situation, necessitating spending cuts or tax rises on top of those planned by the UK government.

Based on the independent Office for Budget Responsibility's (OBR) forecast for further declines in oil revenues and Scotland taking on a population-based share of the UK's public debt, the UK government says that an independent Scotland would have a budget deficit of 5.5% of GDP in 2016–17. This is substantially higher than the UK's 2.4% deficit forecast for that year and means the Scottish Government's budget deficit would be around £1,000 higher per person. Such a large budget deficit would not be sustainable and would require Scotland to make spending cuts or tax rises that were bigger than those planned by the UK.

The UK government then looks 20 years to the future and argues that voting No and staying with the UK would mean a £1,400 per person per year "union dividend" – or, put

another way, a Yes vote would mean a £1,400 “independence penalty”. It argues that most of this penalty would arise from the fact that, under independence, Scotland’s onshore revenues – from income tax, VAT, National Insurance etc – and declining oil revenues would not be enough to pay for the relatively high government spending that Scotland enjoys as part of the UK. They also say there would be set-up costs of independence, costs associated with Scotland’s more rapidly ageing population and the Scottish Government’s proposals for a more generous welfare system. As a new country with no record of repaying creditors, the Scottish Government would need to pay a higher interest rate on its borrowing.

Some people have argued that the UK government’s estimates of the set-up costs of independence are too high and that it has included the cost of more generous policies, but not the benefits. But it is worth noting that, even if these costs were ignored entirely, the extra costs the UK government says would be incurred amount to an “independence penalty” of more than £1,100 per person per year.

### *What does the Yes side say?*

Yes Scotland and the Scottish Government have said oil and gas revenues will increase in future and an independent Scotland’s public finances will be “similar to, or stronger than” the UK’s by 2016–17. The Scottish Government’s central projection is for Scotland’s oil revenues to be about £7 billion in 2016–17, up from £5.6 billion in 2012–13 and about £4.1 billion last year. This is a lot more optimistic than the independent OBR’s forecasts, which imply revenues of about £3 billion in 2016–17.

On the basis of its more optimistic oil revenue figures, the Scottish Government forecasts a budget deficit of 2.8% of GDP in 2016–17, if Scotland took on a population-based share of the UK’s national debt. This compares to a deficit of about 2.1% of GDP for the UK as a whole under such a scenario. If Scotland took on a lower share of the UK debt – which increasingly looks like something the Scottish Government wants to negotiate – Scotland would have less debt interest to pay, so its deficit would be lower.

Looking further ahead, the Scottish Government says it would aim to *increase* public spending a little in 2017–18 and 2018–19 rather than cut it. It says the budget deficit would then fall to 2.2% of GDP in 2018–19, which it says would be “sustainable” and would allow it to start building up an oil fund for the future. But because it would still have a deficit – unlike the UK, which plans to have a small budget surplus by 2018–19 – it would have to borrow the money it was putting in to that fund.

In the longer term, the Scottish Government claims that independence would give it tools to boost the economy. It suggests that *if* an additional 115,000 jobs were created, annual growth in labour productivity were boosted from 2.2% to 2.5%, and net immigration into Scotland were boosted from 16,000 to 24,000 per year, onshore tax receipts would be £5 billion a year higher after 15 years than would be the case without

these improvements. This, they argue, would be a £1,000 per person per year “independence bonus”.

But would it? If an independent Scotland’s government finances would otherwise be similar to the UK’s, an additional £1,000 in revenues clearly would be a bonus. But, unless oil and gas revenues were to rebound and stay high, Scotland’s public finances would be weaker than the UK’s. Although the Scottish Government has published forecasts for oil revenues up to 2018–19 it has not said explicitly what it thinks will happen after that. If oil revenues declined over the longer term, as the OBR forecasts much, or all, of the additional £1,000 would likely be needed to compensate for this and to maintain Scotland’s existing relatively higher levels of government spending. And, if that additional £1,000 did not materialise, taxes would need to go up, or spending cut.

### *What do other experts say?*

Experts at the IFS and at Stirling and Glasgow universities agree that both the Scottish and UK government’s analyses of the starting position in 2016–17 could be correct depending on whose oil revenue forecasts you believe. But, they also suggest that the predictions of the Yes side are based on optimistic assumptions that independence will lead to economic improvement – which might not happen.

For instance, researchers at Glasgow point out that while oil revenues may be higher than forecast by the OBR, they could also be lower. Indeed, the OBR has repeatedly over-predicted rather than under-predicted oil and gas revenues.

David Eiser at Stirling points out that the Scottish Government assumes higher growth without saying much about how it would deliver that extra growth. Similarly, IFS researchers point out that: “whilst it may turn out that the Scottish economy does a great deal better after independence than it would as part of the UK, planning on this as a central assumption seems less than cautious.”

### **So, what is the bottom line?**

It looks likely that the Scottish Government’s finances will be squeezed in the years after 2016 whether the public vote Yes or No. If Scotland remains part of the UK, cuts to grants from Westminster are set to continue until 2018–19. If the vote is to leave the UK, an independent Scottish Government would likely have to make spending cuts or tax rises of its own to restore its finances to health. Delivering the promises in the White Paper would need further tax rises, spending cuts in lower-priority areas or higher borrowing (which would not be sustainable for long).

IFS research shows that the longer term picture is also challenging. Even if oil revenues do rebound over the next few years, Scotland were able to negotiate a favourable deal on the national debt and net immigration were to increase to 26,000 a year, fixing an independent Scotland’s government finances for the long term would probably require

bigger tax rises or spending cuts than the UK will need. This is because if oil revenues do eventually decline, as seems likely, that will knock a much bigger hole in an independent Scotland's budget (oil contributes around 10% of Scotland's total revenues, compared to less than 1% for the UK as a whole).

An independent Scotland could increase some taxes and there would be options for cutting spending. Independence would give more freedom to pursue a different, and perhaps better, economic policy, to undertake the radical, politically challenging reforms that could generate additional growth. But it is much easier to say things would be better *if* the economy grows quicker than it is to develop and implement policies that would actually deliver that extra growth. The Scottish Government has suggested a few policies – such as cuts to corporation tax and expanded childcare – but the immediate effect would be to cost the government money (and hence weaken its finances) and the effects on growth look unlikely to be enough to offset this.

Whether you believe Scotland's government finances would be in a better state if Scotland votes for independence, should depend on two things.

- First, do you think the Scottish Government could find new policies to deliver a sustained increase in economic growth; and
- Second would that additional growth mean higher tax receipts that will more than outweigh the long run decline in oil revenues.

If so then an independent Scotland might be able to continue with its relatively high public spending without much in the way of additional tax increases. If not, the Scottish Government's finances would likely be weaker if the result is Yes.