

The Scottish Referendum

# Scotland's future in the balance



**CIPFA**, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed. As the world's only professional accountancy body to specialise in public services, CIPFA's qualifications are the foundation for a career in public finance. We also champion high performance in public services, translating our experience and insight into clear advice and practical services. Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance.

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The Scottish Referendum

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Beaverbank Business Park  
22 Logie Mill  
Edinburgh  
EH7 4HG  
0131 550 7530

[www.cipfa.org](http://www.cipfa.org)

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# Foreword

As the people of Scotland prepare to vote in the referendum in September, the debate to date has been characterised by two things. First, the unprecedented level of interest in the governance of all of the countries in the UK, and second, the amount of information being produced to support each viewpoint.

Much of that information is finance based, but little of it is easily understandable to the ordinary citizen because of its complexity. Despite the admirable attempts of the various commentators to inform the debate, the risk is that this is having the opposite effect to that intended. Only the headlines are being seen. CIPFA thinks that the decision the Scottish people are being asked to take is vitally important and needs to be supported by financial information that is readily understandable.

Most of us will be familiar with signs which identify 'you are here' on the map. By plotting exactly where we are now, these serve as a graphic reminder of our progress in the journey. Similarly, to gain an understanding of where Scotland is going we must understand clearly where it is now.

In the 15 years since devolution, the situation has not remained static. Regardless of the result of the referendum, further financial powers are already on the way. We therefore think it is critical to locate the 'you are here' spot on Scotland's financial map, and to identify what further financial information is needed to help the Scottish people to make an informed decision. We are doing this because it will be citizens who will determine Scotland's future and not accountants or economists. Our unique role as public finance professionals is to help Scotland's citizens map that journey by breaking down complex financial arguments and aid debate.

In this paper, we introduce the concept of a balance sheet for Scotland's public sector. We demonstrate in understandable language how the use of core financial data can be translated into useful information on what is currently known about Scotland's financial position – and identify what the unknowns are. So if you are asking where are we and how do we decide where we might we go from here – read on. Your journey starts now.



**Rob Whiteman**  
Chief Executive CIPFA



**Don Peebles**  
Head of CIPFA Scotland



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# Executive Summary

Scotland is being asked to vote on whether it should remain part of the UK or whether it should become independent. The demand for information on the state of the public finances in Scotland has never been greater.

There have been many attempts to consider what the public finances of an independent Scotland may look like, but much of this is extremely complex and largely based on a range of assumptions and statistical estimates, which may not reflect the actual position in the event of a yes vote.

CIPFA considers that a clear and understandable picture of Scotland's public finances is essential to fully inform this important national debate. That is why CIPFA has, in the public interest, identified three key questions:

- What is Scotland's current devolved financial position?
- What is the likely impact of constitutional change?
- Would an independent Scotland be financially sustainable?

## WHAT IS SCOTLAND'S CURRENT DEVOLVED FINANCIAL POSITION?

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Limitations of the existing system of funding, means that the Scottish Government does not currently have all the necessary financial levers to manage the public finances to best effect. New financial powers under the Scotland Act 2012 will increase the financial responsibility of the Scottish Government, and provide some levers to enable greater accountability.

Scotland is not currently required to produce a balance sheet for its devolved public sector, a basic management tool which is essential for any organisation, government or country. CIPFA has considered what a devolved Scottish public sector balance sheet might look like. We estimate that:

- Scotland has assets (what we own) of around £84 billion.
- Scotland has liabilities (what we owe) of around £100 billion.

CIPFA concludes that the current financial position of the Scottish public sector under devolved arrangements has similar characteristics to the overall UK position. Irrespective of constitutional reform, publication of a balance sheet as part of consolidated accounts for the devolved Scottish public sector is essential to strong public financial management.

Although our work gives a clearer indication of the Scottish public sector's assets and liabilities, it is not, however, currently possible to form a complete picture of what Scotland's opening financial position would be as an independent nation, because this would be a product of negotiations with the UK Government.

## WHAT IS THE LIKELY IMPACT OF CONSTITUTIONAL CHANGE?

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From our work we acknowledge that there are remaining uncertainties, particularly around the division of assets and liabilities between the UK and an independent Scotland and the impact of the currency arrangements. In terms of the division of liabilities, we consider that items which will significantly impact on 'Scotland's public sector balance sheet' include:

- Scotland's share of the national debt, and
- the public sector pensions liability.

Scotland's share of the national debt could be up to £120 billion, which could result in an annual cost of approximately £4 billion each year. Public sector pensions make up around £75 billion of the existing devolved liabilities in Scotland. In the event of independence, this would increase.

The outcome of the negotiations on the division of assets and liabilities would significantly impact on the Scottish public sector's balance sheet, the future decisions of an independent Scottish Government and its ability to borrow.

These negotiations will also decide Scotland's share of North Sea oil revenues, likely to be a major source of revenue for an independent Scotland.

CIPFA concludes that the outcomes of these negotiations are fundamental to the starting position of an independent Scotland, and the fact that the outcome will not be known until after a vote for independence means that a truly informed decision cannot be made in the referendum.

## WOULD AN INDEPENDENT SCOTLAND BE FINANCIALLY SUSTAINABLE?

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An independent Scotland could spend £69 billion on public services in the proposed year of independence (2016-17), but estimated tax revenue is less than that. This means that there will be a shortfall to be met, but an independent Scottish Government would have the powers and financial levers necessary to manage its financial and economic position sustainably.

Factors likely to impact significantly on the financial sustainability of an independent Scotland include North Sea revenues, the outcome of negotiations on the division of assets and liabilities, and the debt interest rate.

Subject to the impact of these three factors, CIPFA concludes that an independent Scotland's public sector would face similar challenges to the rest of the UK in terms of financial sustainability going forwards. It would be for an independent Scottish Government to utilise the financial tools and levers that would be available to it, to make decisions on taxation, spending and borrowing in order to meet these challenges and ensure that Scottish public services were affordable and sustainable for future generations.

# The Affordability Question

- 1.1 As contributions to the debate on Scottish independence have increased, questions on the financial sustainability of a future Scotland have come to the fore. Generally the debate has revolved around one question – ‘can Scotland afford to be independent?’.
- 1.2 A significant amount of financial data has been released into the public domain which attempts to answer this question. It generally originates from supporters of a particular outcome, although some independent think tanks have also undertaken studies. Most of these works have considered the potential financial and economic impacts of a yes vote in the referendum and the extent to which action would have to be taken to ‘balance the books’.
- 1.3 Yet, it is not always clear from these works what the concept of affordability is being measured against. This is mainly because much of the information required is reported and published on a UK basis only. <sup>1</sup>
- 1.4 The opening financial position of an independent Scotland is currently unknown and would have to be determined through negotiation with the UK Government. Alongside the policy choices that an independent Scottish Government takes, the outcome of this process would have a critical impact on both an independent Scotland’s financial strength, and its ongoing finances.
- 1.5 The Scottish Government has itself recognised this, stating that:  
*Just like any other independent country, the future path for Scotland’s fiscal position will depend upon the policy choices of successive Scottish administrations.*<sup>2</sup>
- 1.6 Because of this lack of clarity on both the opening and the ongoing financial position, much of the information generated to date is extremely complex and based on models or assumptions that are not easily understandable. Yet, it will be citizens who determine Scotland’s future, not accountants or economists.

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1. The Scottish Government produces Government Expenditure and Revenue Scotland (GERS), which provides some information on the public finances of Scotland as a nation. GERS is compiled by statisticians and economists in the Office of the Chief Economic Adviser of the Scottish Government.
2. Scottish Government, *Outlook for Scotland’s Public Finances and the Opportunities of Independence*, 28 May 2014.

1.7 The apparent lack of transparency was an issue highlighted by a committee of the House of Lords when it considered the economic implications of Scottish independence. The committee stated that:

*Given the complexity of these issues, and the relative shortness of time before the referendum, it is of the utmost importance that Scottish voters are presented with the key issues as soon and as clearly as possible.<sup>3</sup>*

1.8 Despite the admirable attempts of commentators to provide that information, the volume and complexity of some of the financial information may actually be preventing the transparency required to achieve an informed view on the debate.

1.9 To add to the uncertainty, constitutional change is already under way. Additional financial powers under the *Scotland Act 2012* will come into effect in 2015, in the form of tax and borrowing powers. In the event of a no vote in the referendum, the political parties have already set out plans to introduce further changes to the devolved settlement. Therefore, the affordability of public services will continue to be critical to Scotland's future.

1.10 **CIPFA concludes:**

- **Much of the debate around the financial aspects of independence has focused on the question of whether Scotland could afford independence.**
- **The affordability of an independent Scotland's public sector would be influenced by the current financial position, negotiations on the terms of separation with the UK Government to determine the opening financial position, and the policy choices of future Scottish governments.**
- **To begin to address the wider affordability question, three crucial areas can be identified:**
  - **Where is Scotland now – what is the current financial position of the devolved Scottish public sector?**
  - **What would be the impact of constitutional change on the financial position of an independent Scotland?**
  - **Would an independent Scotland be financially sustainable?**

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3. House of Lords, Economic Affairs Committee, *Economic Implications for the United Kingdom of Scottish Independence*, April 2013.

# Scotland's Finances as a Devolved Nation

- 2.1 The devolved Scotland we know today was largely set out in the *Scotland Act 1998*.<sup>4</sup> Under this Act, Scotland has powers over domestic areas which are not 'reserved' to the UK. Such reserved areas remain under the control of the UK Government and include defence and national security, the fiscal, economic and monetary system, social security, employment, the civil service, energy and foreign affairs.<sup>5</sup>
- 2.2 The areas in which powers are devolved include health, education, local government, social services, housing, economic development, transport, agriculture, environment, and police and fire services.<sup>6</sup> It is in these areas where Scotland has, over the last 15 years, determined its own legislative and policy choices on how public services will be delivered.
- 2.3 Devolution has led to significant divergence in policy choices between Scotland and the rest of the UK.<sup>7</sup> Such local policy choices lead to different financial commitments, and so the landscape of public spending across the UK is no longer uniform. Despite this divergence, the UK-wide financial management framework does not distinguish the overall financial position of any devolved nation.
- 2.4 Regardless of improvements in recent years, the current financial reporting arrangements for the devolved governments remain closely linked to the UK framework and are not designed to demonstrate an all-Scotland position. In itself this is not a weakness, but for the current debate it prevents us seeing a clear picture of a devolved Scotland's financial position.

## WHAT DOES SCOTLAND CURRENTLY SPEND AND HOW IS THIS FINANCED?

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- 2.5 To begin to identify the current financial position of the Scottish public sector, a useful starting point is Scotland's current funding arrangements; what is spent on public services and the powers available to the Scottish administration to manage its financial position.

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4. [Scotland Act 1998](#).

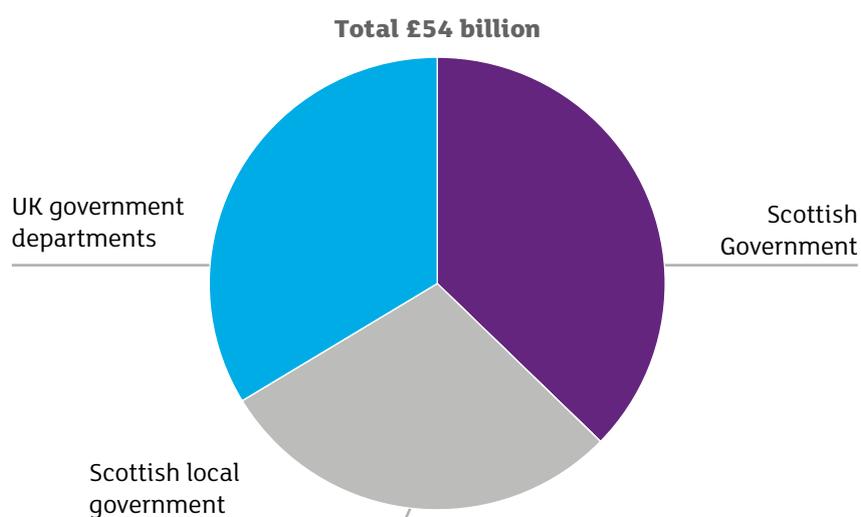
5. A full list of reserved matters is detailed in [Schedule 5](#) to the *Scotland Act 1998*. [Schedule 4](#) also details areas protected from modification by the Scottish Parliament.

6. There is a mechanism, the Sewell Convention, which allows the Westminster Parliament to legislate on devolved areas, with the consent of the Scottish Parliament. Further information on the Sewell Convention can be found in the HoC Library Standard Note, [The Sewell Convention](#), 2005.

7. Such divergence is recognised in the Institute for Fiscal Studies, [Taxation, government spending and the public finances of Scotland: updating the medium term outlook](#), 4 June 2014.

- 2.6 Scotland receives most of its funding in the form of a block grant provided by the UK, supported by some local taxation and grants.<sup>8</sup> The *Scotland Act 1998* also provided a tax-raising power, the Scottish Variable Rate (SVR), although this power has never been used.
- 2.7 Under the current settlement, the Scottish Government is responsible for some but not all of Scotland's public spending.
- 2.8 For the financial year 2012-13, total identifiable spending on all services in Scotland was almost £54 billion.<sup>9</sup> The Scottish Government had control of over £36 billion, or around 66% of this; the remaining non-devolved services are funded directly by the UK Government.

**Figure 1: Public sector spending in Scotland, 2012-13**



Source: HM Treasury, *Country and Regional Analysis, 2013* (Table A.21).

- 2.9 Of this £36 billion for which the Scottish Government is responsible, 84% comes from the UK Government block grant (£30.5 billion in 2012-13).<sup>10</sup>
- 2.10 Other sources of income include sales of services and EU grants (£1.7 billion in 2012-13).<sup>11</sup> In addition to this, local government raises income in the form of council tax and non-domestic rates.

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8. As set out in HM Treasury's *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy*, October 2010.

9. Total identifiable spend under Scottish Parliament/Government control was 66% for 2012-13 (*Country and Regional Analysis 2013*, Table A.21: Identifiable expenditure on services for Scotland, Wales and Northern Ireland in 2011–12). When public spending is analysed on a territorial basis, most is 'identifiable' as being for the benefit of a particular region, eg on schools or hospitals. However, a small proportion is non-identifiable as it cannot be split up as it benefits the UK as a whole. This mainly relates to defence, foreign affairs and debt interest. Such apportionment of public spending is done on a purely statistical basis, and so gives only a broad picture of relative spending for the benefit of the different regions of the UK.

10. Audit Scotland, *Developing financial reporting in Scotland*, July 2013.

11. Audit Scotland, *Reporting of Scottish finances will need to develop further in light of new powers*, July 2013.

## LIMITATIONS OF THE CURRENT SYSTEM OF FUNDING

- 2.11** Strong public financial management<sup>12</sup> is essential for all public sector bodies. It:
- ensures that the public finances are under control – the ability to ‘balance the books’
  - maximises value for public money, and
  - supports improvements and service changes needed for the future.<sup>13</sup>
- 2.12** So does Scotland currently have the necessary tools available to ensure good financial management, ie to ‘balance the books’ and ensure that value for money is obtained from use of public funds?
- 2.13** Funding sourced by a block grant from the UK provides some certainty over levels of funding for Scotland; but it does come with some associated limitations in financial management terms, as discussed in the table below.

**Table 1: Summary of limitations of the current funding system**

<b>Block grant calculated by Barnett formula</b>	<p>The Scottish Government has no control over the level of block grant available and must ensure public services are affordable within the overall funding provided. Although some control can be exercised over levels of local taxation and other funding sources, the block grant provides the majority of Scotland’s income.</p> <p>The Scottish Parliament does have the power to vary income tax by 3p and so generate additional income. This power has never been used. It has been suggested that this is due to the associated complexity and cost,<sup>1</sup> and the limitations on the amount of additional resources it would raise.<sup>2</sup></p>
<b>Limitations on how block grant can be spent</b>	<p>As the UK Government retains control over fiscal policy, HM Treasury imposes controls on the block grant. Although the Scottish Government has discretion over how to spend the majority of the block grant in relation to devolved areas,<sup>3</sup> some more volatile elements of expenditure are restricted.<sup>4</sup></p> <p>Spending in these areas is not within the discretion of the Scottish Ministers, and this funding must be used for the purpose for which it is provided, or returned to HM Treasury. Although this provides the Scottish Government’s funding with an element of protection from the risks associated with such volatile, demand-led elements of spending, it also removes an element of control over the totality of their available funding.</p>

12. CIPFA considers strong public financial management (PFM) to be of utmost importance. PFM is the system by which financial resources are planned, directed and controlled to enable and influence the efficient and effective delivery of public service. It spans a range of activities – including planning and budgeting, management accounting, financial reporting, financial controls, and auditing, all of which contribute to effective, transparent governance and strong public accountability for the use of public money. Further information on financial management can be found in CIPFA, [Public Financial Management: A Whole System Approach](#).
13. As set out in the [CIPFA Financial Management Model](#).

<b>Inability to hold reserves</b>	<p>Funding received in the block grant cannot be held in 'reserve' to be carried over into future financial years.<sup>5</sup> Any unspent grant must be returned to the Treasury at the end of the financial year.</p> <p>There is a system by which the Scottish Government can ask to carry forward any under spend, the budget exchange mechanism.<sup>6</sup> However, this is subject to limits, and is designed to avoid the 'use it or lose it' effect, rather than to manage financial pressures across years. This does not enable the funds to be held in a 'reserve' but rather allows access to the agreed amount in the next financial year.</p>
<b>Inability to borrow over the long term</b>	<p>Local government in Scotland can borrow money, as long as this is affordable and prudent.<sup>7</sup> This enables authorities to spread the cost of capital investment in schools, roads and other infrastructure, over a number of years.</p> <p>Under the current settlement, the Scottish Government has only limited ability to borrow money, with the power to borrow up to £500 million to cover temporary shortfalls.<sup>8</sup> Since devolution this power has never been used.</p>
<b>Limited information on future funding levels</b>	<p>In terms of financial planning for the future, the Scottish Government has only restricted information on its future level of funding. Although the block grant does provide a level of certainty, the amount of grant to be received is indicated as part of the UK Government's Spending Review process.<sup>9</sup> However, the timing and lengths of Spending Review periods have varied, with the Spending Round 2013 providing figures for only two years (2014-15 and 2015-16), with no forecasts for financial years beyond the next UK general election.</p> <p>Spending Reviews provide an indication of what the block grant is likely to be, but these plans are often altered by decisions in UK Government Budgets and Autumn Statements, and therefore the block grant figures are subject to change, in either direction.</p> <p>These issues of timing and changes to the level of grant present difficulties in the ability of the Scottish Government to establish medium or long term financial plans.</p>

*Notes:*

1. Scottish Government, *Scottish Variable Rate*.
2. Devolution Matters, *The uselessness of the Scottish Variable Rate*, November 2010.
3. *The departmental expenditure limits (DEL)*.
4. *Included in the annually managed expenditure (AME)*.
6. As detailed in HM Treasury's *Consolidated Budgeting Guidance 2013 to 2014*.
7. SSI 2004/29 *The Local Government Capital Expenditure Limits (Scotland) Regulations 2004*.
8. Scotland Act 1998, *Section 66*.
9. *Three year plans apply to the bulk of the grant, the departmental expenditure limit (DEL). However, the more volatile annually managed expenditure (AME) is planned for on an annual basis.*

- 2.14 Together, these limitations impose restrictions on the choices available to 'balance the books'. As the Scottish Government has little control over its overall level of funding and there are restrictions on how some of it can be used, it has no choice but to balance the books annually. This creates difficulties in financial planning for the sustainable delivery of public services in future years.
- 2.15 The inability to borrow or to hold money in reserve can be compared to that of an individual. An individual can save money for the future and can borrow money for a large investment. But these basic tools are not available to the Scottish Government under the current settlement.
- 2.16 Despite the limitations inherent in the current funding system, Scottish Governments under devolution have managed to balance the books and manage their finances.
- 2.17 **CIPFA concludes:**
- **The Scottish Government is currently responsible for public spending in Scotland of around £36 billion, which is mainly funded by block grant and represents over 60% of all public spending in Scotland.**
  - **The block grant provides Scotland with some certainty over the level of funding it will receive but the wider control framework does not provide the Scottish Government with all the necessary financial levers required for optimum public financial management and accountability.**
  - **Devolution has led to significant divergence in policy choices between Scotland and the rest of the UK but the current UK financial framework does not enable the financial position of a devolved Scotland's public sector to be separately reported.**



# Finding a Scottish Balance

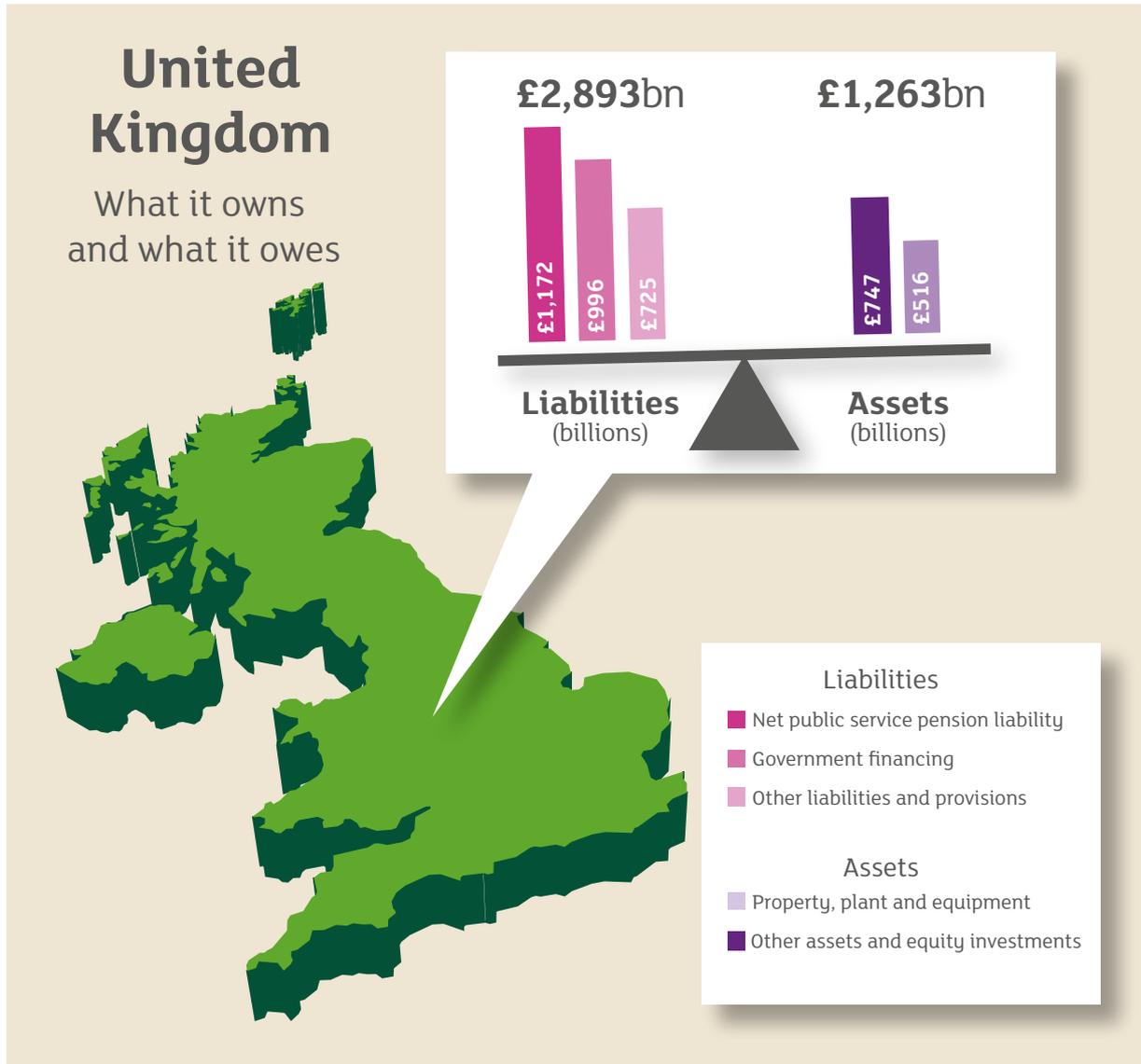
- 3.1** Strong public financial management is not dependent upon the outcome of the referendum and is essential in any public sector body. The overall financial position of the Scottish public sector should therefore be more clearly reported to the people of Scotland, regardless of constitutional change.
- 3.2** A clear picture of the financial position of the Scottish public sector under current arrangements would also help clarify where Scotland stands now, and provide a starting point on which to base the decisions about its future direction and whether it would be affordable and sustainable.

## WHAT IS A BALANCE SHEET?

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- 3.3** A balance sheet provides a picture of an organisation's current financial position. It shows assets and liabilities (what is owned and owed) and it provides a net position at a given point in time.
- 3.4** The public sector owns assets in the form of plant, property or equipment, including its investment in infrastructure such as roads, hospitals, or schools. Other assets include IT systems, investments, and cash held. Liabilities include financial commitments entered into, such as finance leases, provision for compensation claims and borrowing.
- 3.5** Both assets and liabilities are classified by timescale; those expected to be settled within one year (current) and those which extend over a longer timescale (non-current). This enables identification of what is owned/owed in the current financial year, and what is owned/owed into the future as a result of past activities.
- 3.6** The balance sheet can be viewed as a scale on which the assets and liabilities are weighed up; simplistically, the assets (owned) represent resources with which liabilities (amounts owed) must be settled. The balance of the assets against the liabilities shows the net financial position. As we are dealing with the public finances here, this is sometimes known as taxpayer's equity, as ultimately all public services are funded by the taxpayer.
- 3.7** It is common for governments to have a negative equity position, where liabilities exceed assets, ie more is owed than owned. This is demonstrated clearly by the UK public sector balance sheet.

Figure 2: What the UK public sector owns and what it owes, 31 March 2013



Source: HM Treasury, *Whole of Government Accounts: year ended 31 March 2013* (Chart 2.4).

3.8 There are limits to what a balance sheet alone can tell us about the financial position or sustainability of the public sector finances. A balance sheet provides only a snapshot of the position at a particular point in time, and takes account of only past activity. It provides no indication of overall future policy-based spending commitments, or of the ability to raise taxes as a source of income.

## A BALANCE SHEET FOR SCOTLAND'S PUBLIC SECTOR

3.9 The Scottish Government produced a report entitled *Scotland's Balance Sheet*.<sup>14</sup> This provided an 'analysis of Scotland's public finances under the current fiscal framework'.<sup>15</sup> It aimed to give holistic estimates of the public finances, and so included estimates of spending against

14. Scottish Government, *Scotland's Balance Sheet*, April 2013.

15. Scottish Government, *Scotland's Balance Sheet*, April 2013.

income, but did not capture the wider assets and liabilities. Therefore, it does not represent a conventional balance sheet.

- 3.10** Although Scotland is not required to produce an overall balance sheet for its devolved public sector, in order to start building a picture of the Scottish public sector's finances, we have undertaken an analysis of most of the audited balance sheets that are available for different parts of the Scottish public sector.<sup>16</sup> The information in these balance sheets provides an indication of the financial position of the Scottish public sector under current arrangements.

## SCOTLAND'S ASSETS

- 3.11** We have estimated that Scotland's devolved government and wider public sector have assets of approximately £84.4 billion, as shown in figure 3.
- 3.12** Public assets of course are used for service delivery rather than for resale or creation of profit. Nevertheless, this indicates the extent of infrastructure owned by the Scottish public sector, such as schools, hospitals and roads.
- 3.13** In terms of assets, property, plant and equipment make up most of the public sector's assets – around 82%. Of this, around 26% of total assets relate to the road network (both the trunk road network on the Scottish Government's balance sheet and local road networks on local government balance sheets). The scale of these assets highlights the importance of the road network as a key infrastructure asset of the Scottish public sector.<sup>17</sup> Whereas local roads are valued at historical cost, the trunk road network is valued at depreciated replacement cost. If the entire road network were to be valued at replacement cost, it is estimated that the value of these assets could increase by around £50 billion.<sup>18</sup>
- 3.14** Ownership of assets comes with the responsibility to maintain them, despite the recent reductions in public spending. Recent reports indicate that the overall condition of the public sector's assets is not known and that there is a significant maintenance backlog. These reports have been directed at the NHS,<sup>19</sup> local government<sup>20</sup> and the road network.<sup>21</sup>
- 3.15** This evidences the need for better management of the public sector assets to ensure that they are delivering best value for the public pound, including through saving money in the longer term by reducing the need to replace assets. These ongoing maintenance obligations will have to be factored in to the spending decisions of public bodies and governments.

16. Further information on our analysis and the public bodies included can be found here: [Methodology to identify the assets and liabilities of the Scottish public sector](#).

17. It should be noted that within the assets considered, there is inconsistency in how these are valued. Some are valued at historic cost and others at current replacement value, indicating a lack of alignment in the accounting policies adopted by the public sector bodies considered.

18. Audit Scotland, [Developing financial reporting in Scotland](#), July 2013.

19. Audit Scotland, [Asset management in the NHS in Scotland](#), January 2009 and Scottish Government, [Annual State of the NHS Scotland Assets and Facilities Report for 2012](#), December 2012.

20. Audit Scotland, [Asset management in local government](#), May 2009.

21. Audit Scotland, [Maintaining Scotland's roads: A follow-up report](#), February 2011.

## SCOTLAND'S LIABILITIES

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- 3.16** We have estimated that Scotland's devolved public sector has liabilities of approximately £100.7 billion, as shown in figure 3.
- 3.17** Currently the Scottish Government does not have the ability to borrow, but local authorities do, and their balance sheets reflect some £10.5 billion related to long-term borrowing, around 10.4% of the total public sector liabilities. Such future commitments to repay borrowing must be factored in to long-term financial planning and the potential impact on future service delivery considered.
- 3.18** Liabilities such as finance leases, and similar arrangements like private finance initiative (PFI) or non-profit distributing (NPD) contracts represent a mechanism of acquiring assets (such as roads, schools or hospitals) which are financed and delivered by the private sector and paid for by the public sector over future years. Such contracts provide a way of investing in assets related to service delivery, in the absence of the ability of the Scottish Government to borrow.
- 3.19** Such arrangements are generally long term, 25 to 30 years. It is important that the commitments to repay such contracts are recognised, and their impact on future service delivery is clear and incorporated into long-term financial planning to ensure that they are sustainable and affordable for future generations.

## PUBLIC SECTOR PENSION LIABILITIES

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- 3.20** The most significant liability of the UK public sector relates to employee pension liabilities (as shown in figure 2), with commitments extending many years into the future, as people retire and their pensions become payable. It is clearly important that such liabilities are recognised and that their impact on future spending and service delivery is included within longer-term financial planning.
- 3.21** Our summary of public sector balance sheets in Scotland identifies potential public service pensions liabilities of £74.9 billion, around 74% of the total public sector liabilities, as shown in figure 3. These include:
- Local government pension liabilities of £8.8 billion reported in local authority accounts.
  - Pension liabilities of £53.1 billion for NHS and Scottish teachers' pension schemes which are managed by the Scottish Public Pensions Agency (SPPA) and reported in separate accounts.
  - Police and fire pension liabilities and injury benefits of £12.5 billion reported in joint board accounts.<sup>22</sup>
- 3.22** Pension liabilities for NHS, teachers, police and fire schemes are 'unfunded', in that there is no investment fund to draw on to meet these commitments; rather they are met from current revenue or taxation income.
- 3.23** Pension liabilities for civil servants working for the Scottish Government are not included on its balance sheet; they are reported only at a UK level. To estimate the Scottish Government's

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22. Dumfries and Galloway and Fife fire and police pension liabilities were reported in their local authority accounts. Other police and fire pension liabilities were reported in joint board accounts.

pension liability for its own civil servants under the current arrangements, we would need to know the pension liability due to civil servants, both present and past, working in Scotland in devolved areas.

- 3.24** These figures are not available, as the civil service scheme reports only on a UK-wide basis. However, figures are available on the number of civil servants currently working on devolved matters in Scotland,<sup>23</sup> and the total number of members of the civil service pension scheme.<sup>24</sup> Using these figures, we have estimated that the potential impact of these pension liabilities on the Scottish Government's balance sheet could be around an additional £5.7 billion.<sup>25</sup> This estimate is not included in the £74.9 billion pension liability discussed above, but would be in addition to this, and thus would increase the level of Scotland's liabilities.<sup>26</sup> It should be noted that in the event of independence, pension liabilities for those civil servants working on matters reserved to the UK may also have to be considered, which could result in further additional liabilities of around £9.7 billion.<sup>27</sup>

## A DEVOLVED SCOTLAND'S BALANCE SHEET

- 3.25** We can now use our estimates of a devolved Scotland's assets and liabilities from the individual financial statements to begin to bring together these assets and obligations to form the foundations for a balance sheet.

23. Scottish Government, [Public Sector Employment in Scotland](#), Q3 2013.

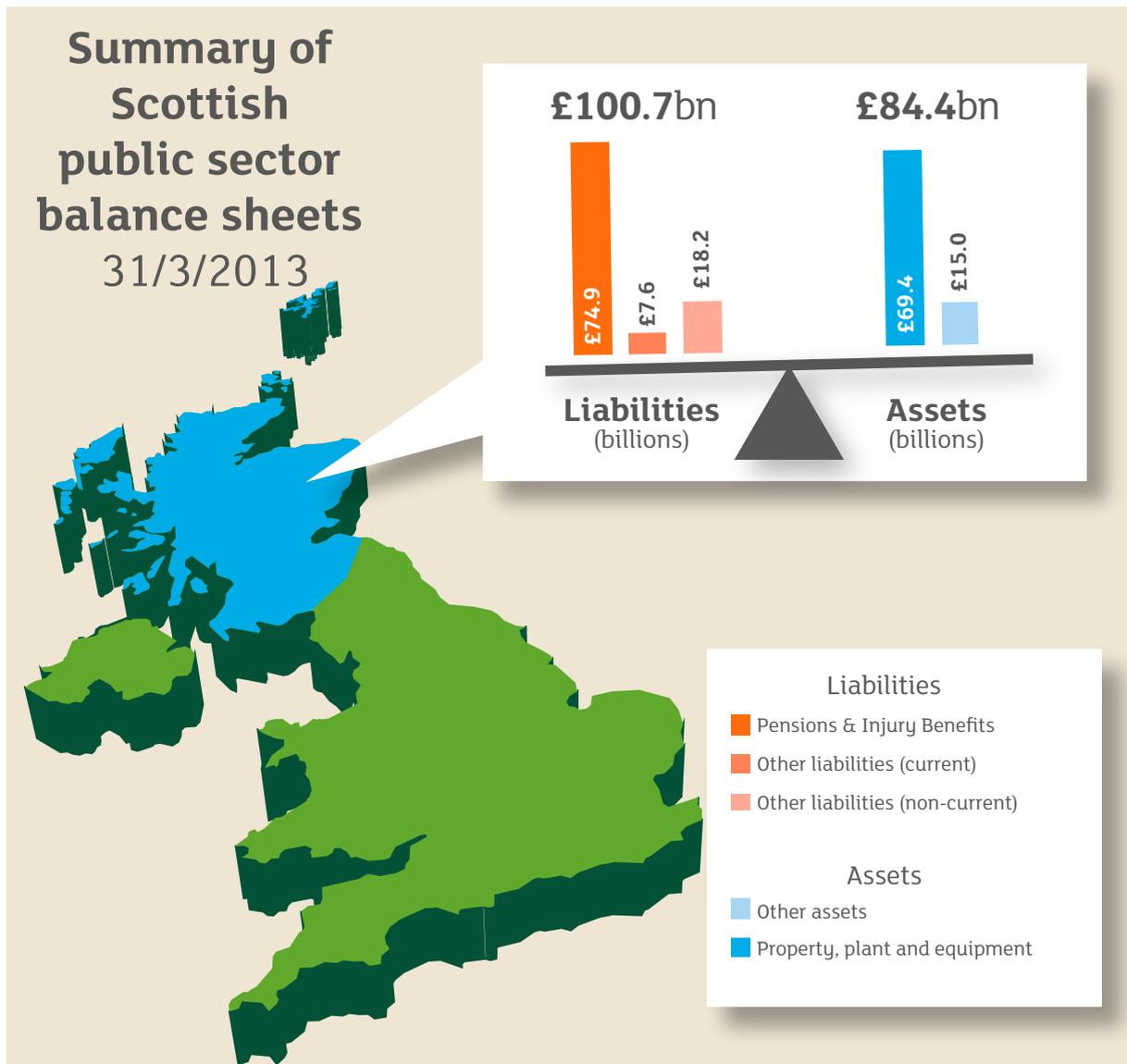
24. Cabinet Office, [Civil Superannuation Accounts 2011-12](#).

25. Scottish Government, [Public Sector Employment in Scotland](#), Q3 2013 demonstrates that there were 16,800 civil servants working on devolved activities in Scotland. Cabinet Office, [Civil Service Superannuation Accounts 2012-13](#) shows that membership of PCSPS in 2013 was 1,530,000, comprised of 510,000 active, 369,000 deferred and 651,300 pensioners in payment. HM Treasury, [Whole of Government Accounts: Year ended 31 March 2013](#), June 2014 show that the UK-wide liability relating to civil service pensions in 2012-13 was £176.5 billion. Assuming that all devolved civil servants are members of the PCSPS, then the proportion of active members employed on devolved activities in Scotland is 3.29%. Assuming that this proportion applies equally across the deferred members and existing pensioners, and that the range and structure of grades are similar in the Scottish Government as across the UK, then we can use this proportion to calculate the share of the UK liability of £176.5 billion attributable to Scottish Government employees working on devolved activities as being around £5.7 billion. Applying a margin for error/variation of 10% gives a range of £5.1 to £6.2 billion. In the event of independence, if civil servants currently working on reserved matters in Scotland remain in the employ of a Scottish civil service, a similar calculation would give additional potential liabilities of £9.7 billion (£8.7 billion to £10.6 billion, applying a 10% margin of error).

26. It is important to note that the commitments associated with pensions extend significantly into the long term. This makes the estimation of pension liabilities uncertain, complex and very sensitive to the underlying assumptions used, for instance regarding life expectancy. Therefore there can be significant change in the estimated liability from one financial year to the next.

27. See footnote 25.

Figure 3: Summary of Scottish public sector balance sheets, 31 March 2013



Source: CIPFA analysis of public sector financial statements, 2012-13.

3.26 The overall position of the Scottish public sector is a net liability of around £16 billion; a significantly smaller net liability position than the £1.6 trillion shown above for the UK as a whole (see figure 2). This mainly reflects the fact that the UK Government’s balance sheet includes liability for public sector debt of around £996 billion,<sup>28</sup> as well as other elements reported on a UK-wide basis, such as civil service pension liabilities. In the event of independence, the division of assets and liabilities would have to be negotiated, including a share of the national debt (discussed in section 5). The result of these negotiations would significantly impact on the Scottish public sector’s balance sheet, and the scale of its net liability position.

28. HM Treasury, *Whole of Government Accounts: year ended 31 March 2012* (page 10).

**3.27 CIPFA concludes:**

- CIPFA estimates that the devolved Scottish public sector has assets of £84.4 billion and liabilities of £100.7 billion.
- The overall position of the existing Scottish public sector is a net liability of around £16 billion.
- Public sector pensions make up around £75 billion of the total Scottish public sector liabilities, and represent a significant call on public finances going forward.
- Although we can gain a clearer idea of the Scottish public sector's assets and liabilities, it is not currently possible to form a complete picture due to the lack of information on a Scotland-only basis.
- The UK has a net liability of around £1,630 billion. In the event of a vote for independence, the division of assets and liabilities between Scotland and the rest of the UK would have to be negotiated, with a resulting impact on any Scottish public sector balance sheet.
- Going forward, a balance sheet for the Scottish public sector and alignment of the accounting policies used, combined with the necessary financial levers, would provide a sound basis for assessing the future affordability and sustainability of the public services in Scotland, regardless of constitutional change.



# CHAPTER FOUR

## The Balance is Already Changing

### THE SCOTLAND ACT 2012

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- 4.1** Since the 1998 Act, devolution has not remained static. There has been some flexibility and further transfer of powers from the UK. By far the greatest transfer of powers to date has come through the *Scotland Act 2012*, which devolves significant financial powers on taxation and borrowing to Scotland.<sup>29</sup> This Act provides:
- powers to set a Scottish Rate of Income Tax (SRIT), to replace 10% of UK income tax in Scotland from April 2016
  - full devolution of taxation on land transactions and disposals to landfill from April 2015
  - capital borrowing powers from April 2015, and
  - revenue borrowing powers to manage differences between forecasts and actual tax receipts.
- 4.2** The Act also includes a mechanism for further tax devolution in the future.
- 4.3** This devolution of tax powers will be accompanied by a corresponding reduction to the block grant received from the UK. With the implementation of the Act, the Scottish Government will fund a higher proportion of the spending for which it is responsible, rising from around 16% to 29%, based on the 2012-13 financial year.<sup>30</sup>
- 4.4** In the event of a yes vote in September, the Scottish Government proposes independence by March 2016. As can be seen from the timetable above, the powers to be transferred under the 2012 Act will already have come into effect, or in the case of SRIT, will be about to come into effect, by the proposed independence day. The question is what will be required to manage these greater financial freedoms.

### TAX REVENUES IN A DEVOLVED SCOTLAND

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- 4.5** The public sector can manage its liabilities by relying on future income from tax revenues, reducing levels of public spending, borrowing, or a combination of these three options.
- 4.6** The income from future taxation impacts on the levels of overall funding available for public services and so is an important factor when assessing the financial sustainability of public services. In turn, these factors can influence the decisions made on tax policy.

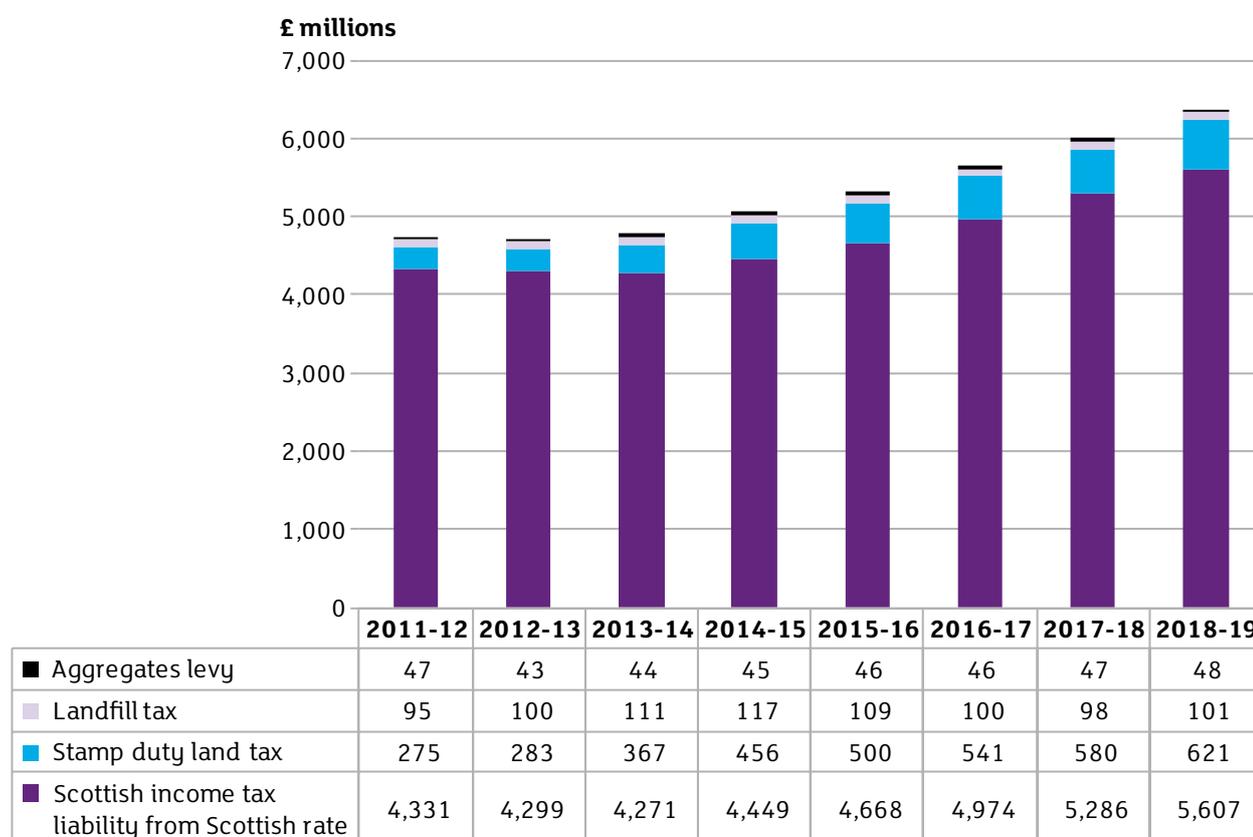
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29. *Scotland Act 2012*.

30. OBR, *Economic and fiscal outlook: Scottish tax forecasts*, March 2014.

- 4.7 To see the likely future income from the taxes to be devolved relies on forecasts produced by the Office for Budget Responsibility (OBR). In doing so, they cannot use the same methodology as for UK forecasts, due to a lack of available data for Scotland only. So, the forecasts are based on Scotland's historic share of the relevant UK tax, and assume that this remains at the recent average level.<sup>31</sup>
- 4.8 The forecasts are based on the current UK policy for each tax, which may differ from the actual tax policy implemented by the Scottish Government. For example, legislation has already set out differing policies to replace stamp duty and landfill taxes in Scotland.<sup>32</sup> The following shows the latest forecasts for the income from devolved taxes.

**Figure 4: Summary of Scottish tax forecasts, March 2014**



Source: OBR, *Economic and Fiscal Outlook: Scottish Tax Forecasts*, March 2014.

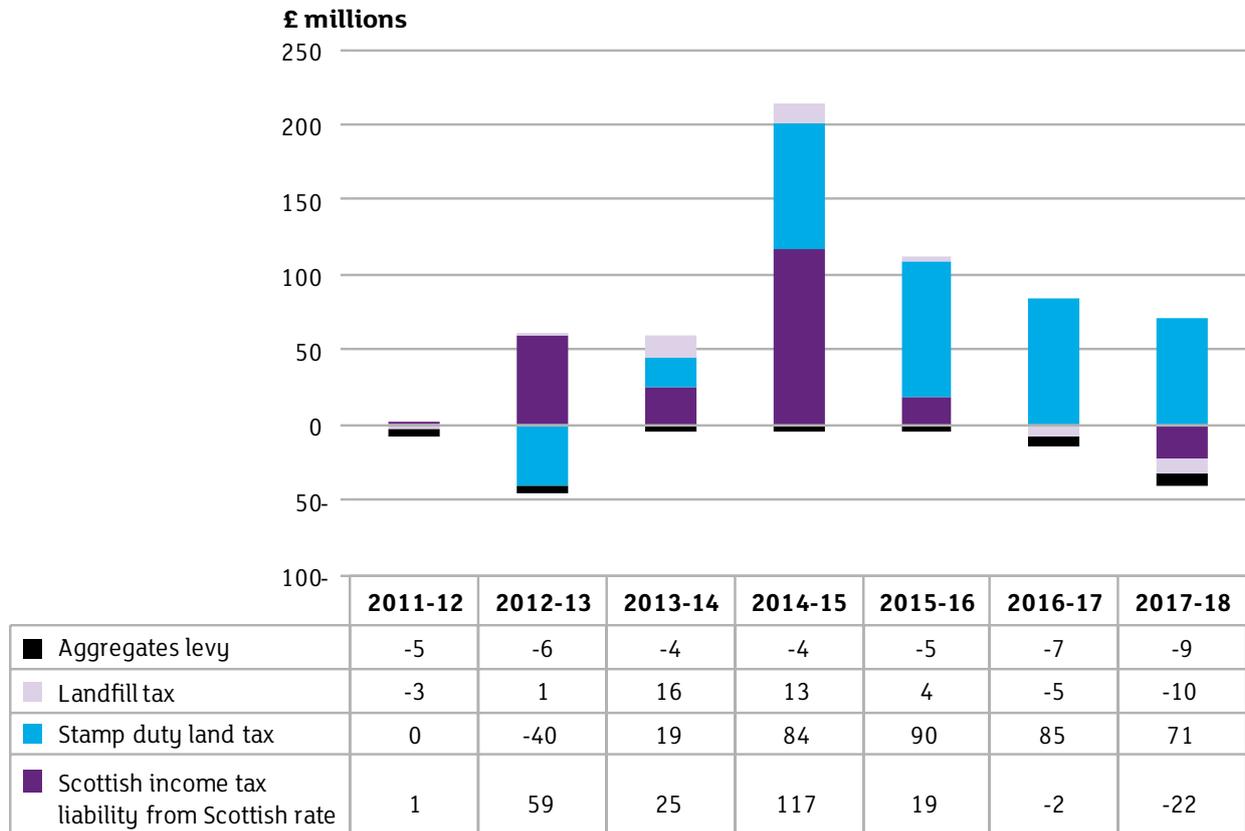
Note: Forecasts assume that the 10p rate of SRIT is levied and that current rates of other taxes are retained.

31. OBR, *Methodology Note: Forecasting Scottish taxes*, March 2012.

32. Scottish replacement taxes have been legislated for in the *Land and Buildings Transaction Tax (Scotland) Act 2013* and the *Landfill Tax (Scotland) Act 2014*.

- 4.9 These forecasts are subject to change due to a number of factors, including growth forecasts for the wider economy and changes to tax policy. Concerns have been raised about the level of variance in these forecasts.<sup>33</sup> If we consider how the most recent forecasts differ from those published one year ago, we can see the extent of the difference.

**Figure 5: Variation in Scottish tax forecasts between March 2013 and March 2014**



Source: OBR, *Economic and fiscal outlook: Scottish tax forecasts, March 2014 and March 2013*.

Note: Forecasts assume that the 10p rate of SRIT is levied and that current rates of other taxes are retained.

- 4.10 So, while the devolution of tax powers will give greater autonomy and accountability to the Scottish Government, it will also mean that there is the potential for greater variability in its income, as it will be exposed to changes in the levels of tax income, whether due to economic performance or to forecasting errors. In turn, this will have implications for wider policy decisions and the future sustainability of public services.

33. Scottish Parliament, Finance Committee, *8th Report 2013 (Session 4) Report on implementation of the financial powers in the Scotland Act 2012*, October 2013.

## BORROWING IN A DEVOLVED SCOTLAND

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- 4.11 The *Scotland Act 2012* provides new capital borrowing powers from April 2015 for investment in infrastructure. The Scottish Government will be able to borrow up to 10% of their capital budget<sup>34</sup> in any one year, with a cumulative limit of £2.2 billion over ten years.
- 4.12 The UK Government has announced that the capital borrowing limit for 2015-16 will be £296 million, and the Scottish Government has indicated that it intends to utilise the entire amount to support capital investment.<sup>35</sup> The Cabinet Secretary for Finance stated that:
- We will use capital borrowing powers to support investment in assets with long life spans. By matching loan terms to the lifespan of assets, the Scottish Government will improve affordability by spreading the cost of repaying loans.*<sup>36</sup>
- 4.13 Recently the UK Government has announced that the Scottish Government will be able to issue bonds. This will not alter the levels of borrowing available, but provides an additional source of borrowing, allowing the Scottish Government to directly access the capital markets and issue its own debt.<sup>37</sup>
- 4.14 This capital borrowing power would impact on the theoretical balance sheet, in terms of both increased assets (the infrastructure investment) and increased liabilities (the obligation to repay debt). The power will also mean a commitment to meet repayments on borrowing in the future, and so will impact on the financial sustainability of public services going forward.

## HOW WILL THE SCOTLAND ACT 2012 IMPACT ON FINANCIAL MANAGEMENT?

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- 4.15 Tax powers will give the Scottish Government more control over the amount of revenue it raises (although this will be offset by a reduction from the block grant) and make it more financially accountable to Scottish taxpayers. Borrowing powers will enable greater flexibility to spread the costs of infrastructure investment, and so service provision, over financial years, but will result in an accompanying commitment to repay the debt in future years. However the majority of Scotland's income will still be in the form of the block grant, with the accompanying restrictions and limitations on financial planning and management.
- 4.16 For areas in which the Scottish Government has adopted different policies from the rest of the UK (such as prescription charges, higher education tuition fees and social care), funding for such policies is not 'built into' the block grant (which is calculated on the basis of UK spending policies), but must be found from within the available funding.
- 4.17 This means that the Scottish Government must prioritise and make choices to fund such policies, possibly at the expense of other areas. These policies also commit to meeting costs in future years, and as we have seen previously, assessing their sustainability going forward is

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34. Capital departmental expenditure limit (DEL).

35. Scottish Parliament, Finance Committee, *Official Report*, 4 September 2013.

36. Scottish Parliament, Finance Committee, *8th Report 2013 (Session 4) Report on implementation of the financial powers in the Scotland Act 2012*, October 2013.

37. HM Treasury and Scotland Office, *Scotland to be given powers to issue its own bonds*, 19 February 2014.

limited by the information available on future years' funding. Given the reductions to public spending in recent years, and indications that such cuts are likely to continue over the next UK Parliament,<sup>38</sup> assessing the affordability and financial sustainability of such differing policies is of increasing importance.

- 4.18** There are some areas for which the Scottish Government receives funding, and has responsibility, but the UK Government carries the risk of increased demand.<sup>39</sup> Such annually managed expenditure accounted for some £5.8 billion, or around 16% of the Scottish Government's 2014-15 budget.<sup>40</sup> The true extent of the potential liabilities associated with such annually managed expenditure is difficult to identify and separate.
- 4.19** Issues such as this make the picture of the Scottish public sector's actual financial position under devolution more opaque than it would first seem, and mean that the ability to identify the precise financial 'you are here' spot is difficult under the current financial structure and reporting framework.
- 4.20 CIPFA concludes:**
- **New financial powers under the *Scotland Act 2012* will increase the financial responsibility and accountability of the Scottish Government, and provide better levers.**
  - **The devolution of tax powers in the 2012 Act means the Scottish Government will fund a higher proportion of the spending for which it is responsible, making it more accountable to Scottish taxpayers. However, it will also carry the risk of variability in the levels of income available.**
  - **Borrowing powers will enable the Scottish Government to increase its asset base by spreading the cost of infrastructure investment, but will also increase liabilities in the commitment to meet repayments on borrowing.**

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38. HM Treasury, [Budget 2014](#), March 2014 (para 1.69).

39. Funding for such areas is generally provided in the form of annually managed expenditure (AME). This is negotiated with the UK Government and provided as required. For example, some aspects of public sector pensions are funded in this manner.

40. Scottish Government, [Draft Budget 2014-15](#), September 2013.



# Financial Sustainability in an Independent Scotland

- 5.1** A yes vote in September 2014 would pave the way for Scotland to become an independent nation and would fundamentally change the fiscal landscape of Scotland. The Scottish Government would have control over all tax and spending decisions and the balance sheet of the Scottish public sector would need to accommodate the transfer of assets and liabilities under the constitutional settlement reached.
- 5.2** There are contrasting views as to what the opening financial position of an independent Scotland would be, from the Scottish Government's position that:

*Scotland is a wealthy country and can more than afford to be independent.*<sup>41</sup>

to that of the Institute for Fiscal Studies' assessment that:

*... the public finance challenges facing an independent Scotland would appear to face more substantial challenges than the UK. This largely reflects the weaker initial position of Scotland's public finances and the likely long-run decline in revenues from oil and gas production, which will have a more significant effect on Scotland's fiscal position than that of the UK as a whole. This means that Scotland would likely need to implement further tax increases and/or spending cuts after 2016-17 to achieve a sustainable fiscal position, above and beyond those required by the UK.*<sup>42</sup>

- 5.3** The UK Government has suggested that independence would cost £1,400 per year for each Scottish person in higher taxes and/or lower public spending over the next 20 years,<sup>43</sup> whereas the Scottish Government estimates that by using the powers of independence to grow the economy, Scotland could be £5 billion per year better off by 2029-30.<sup>44</sup>

## HOW WILL CONSTITUTIONAL CHANGES IMPACT ON FINANCIAL SUSTAINABILITY?

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- 5.4** To begin to consider the financial sustainability of public services in the future, a longer-term view is needed. Not only must the present assets and liabilities be known, but estimates of future tax revenues and spending also need to be considered.

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41. Scottish Government, *Scotland's Future*, November 2014.

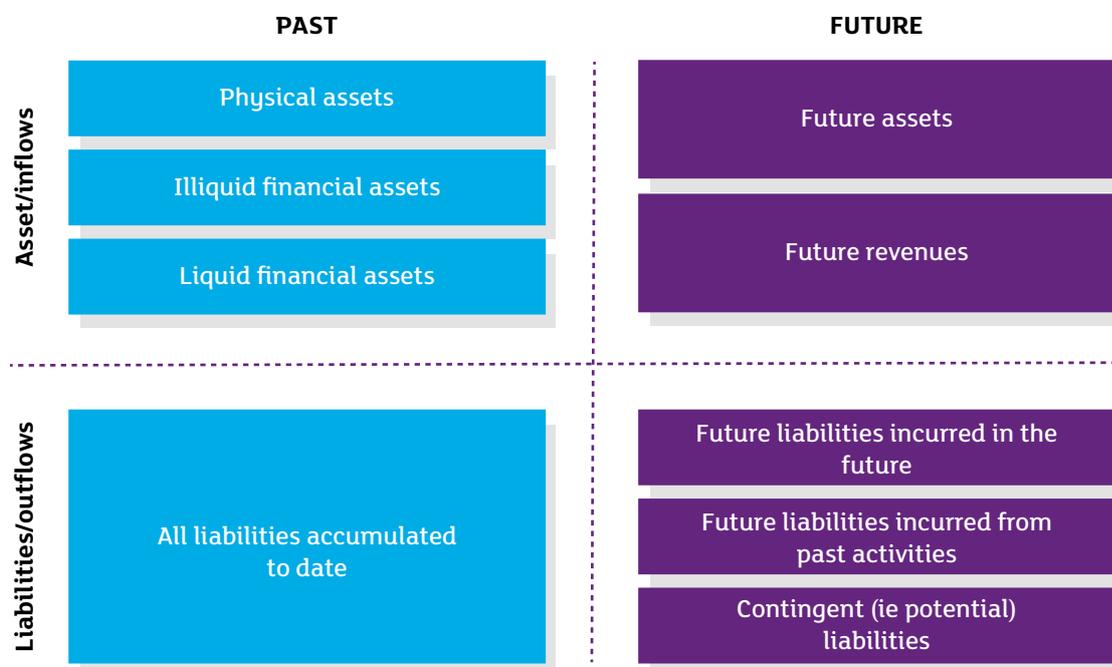
42. Institute for Fiscal Studies, *Taxation, government spending and the public finances of Scotland: updating the medium term outlook*, 4 June 2014.

43. HM Government, *Scotland Analysis: Fiscal policy and sustainability*, 28 May 2014.

44. Scottish Government, *Outlook for Scotland's Public Finances and the Opportunities of Independence*, 28 May 2014.

5.5 Long-term financial sustainability is the ability to meet service delivery and financial commitments both now and in the future.<sup>45</sup> It involves projecting the income and financial commitments related to service provision over a longer time period. The following diagram illustrates this.

**Figure 6: Past stocks and future flows**



Source: OBR, *Fiscal Sustainability Report*, July 2013.

- 5.6 Characteristics of organisations which should produce long-term financial sustainability information are defined as those which have:
- significant tax and/or other revenue raising powers
  - powers to incur significant debt, or
  - power and ability to determine the nature, level and method of service delivery including the introduction of new services.<sup>46</sup>
- 5.7 By these criteria, given the level of influence of the Scottish Government and wider public sector over service delivery, regardless of future powers over tax or debt, clearly there should be some consideration of the sustainability of the public finances over the long term.
- 5.8 From our analysis of public sector balance sheets (summarised in figure 3), the starting point is the control of assets of £84.4 billion and more significantly, the need to service liabilities of £100.7 billion. This means that the key question on affordability can now be subdivided into:
- What would be the opening financial position of an independent Scotland?
  - What would be an independent Scotland's likely level of public spending?
  - What would be an independent Scotland's estimated total tax revenue?
  - Would tax revenues raised be enough to support public services?

45. IPSASB, *Reporting on the Long-Term Sustainability of an Entity's Finances*.

46. IPSASB, *Reporting on the Long-Term Sustainability of an Entity's Finances*.

## WHAT WOULD BE THE OPENING FINANCIAL POSITION OF AN INDEPENDENT SCOTLAND?

- 5.9 One of the first issues to be addressed following a yes vote in the referendum would be the starting position of Scotland and how UK-wide assets and liabilities would be divided up between Scotland and the rest of the UK.
- 5.10 The transfer of assets and liabilities would need to be settled by a political process of negotiations. Examples of the assets and liabilities which may have to be negotiated include:
- North Sea oil and gas
  - national debt
  - physical assets in Scotland supporting reserved services, such as defence and welfare, and those elsewhere to which Scotland has contributed
  - other financial assets and liabilities, such as shareholdings in banks, investments and provisions for nuclear decommissioning, etc.
- 5.11 There are no clear international rules, precedents, or consensus on the division of assets and liabilities in cases of state succession. There is a UN convention<sup>47</sup> which suggests how state property and debt be divided up in such cases, but this has yet to be ratified and so is not yet in force.
- 5.12 Many commentators have considered simply dividing the assets and liabilities on the basis of relative population, ie taking 8.4% of the totals,<sup>48</sup> or by geographic location. Such approaches have been adopted due to the lack of available alternative information, so it is not possible to identify how much of each asset or liability is attributable to a particular region. However, this approach may not be sufficiently robust and for many of the items under consideration, the assumptions on which these figures are based are unlikely to reflect the approach taken in any negotiations.
- 5.13 For example, the Scottish Government has proposed splitting national debt on the basis of a zero share, its 'historic share' of debt, or on the basis of population, giving a potential debt share of between £0 and £120 billion,<sup>49</sup> whereas the UK Government seems to favour a split on a population basis.<sup>50</sup>
- 5.14 The Scottish Government envisages offsetting its share of the national debt with the transfer of an '*equitable share of the UK public sector assets*'.<sup>51</sup> The UK Government recognises that

47. United Nations, *Vienna Convention on Succession of States in respect of State Property, Archives and Debts* 1983.

48. According to the ONS, *Statistical bulletin: 2011 Census: Population Estimates for the United Kingdom*, 27 March 2011, the total UK population is 63.2 million and Scotland's population is 5.3 million or 8.4% of the total.

49. Scottish Government, *Outlook for Scotland's Public Finances and the Opportunities of Independence*, 28 May 2014.

50. HM Government, *Scotland Analysis: Fiscal policy and sustainability*, 28 May 2014.

51. Scottish Government, *Outlook for Scotland's Public Finances and the Opportunities of Independence*, 28 May 2014.

*'Scotland would be entitled to a share of UK assets' but that neither side 'is likely to be made substantially better or worse off' through the transfer of such assets.<sup>52</sup>*

- 5.15** Both the Scottish and the UK Government recognise that negotiations leading to independence would involve identifying respective shares of the UK's assets and liabilities. The Scottish Government has stated that:

*Issues to be resolved would include the division of financial and other assets and liabilities including oil revenues and assignation of other tax revenues, military bases and overseas assets...<sup>53</sup>*

- 5.16** The UK Government has stated:

*The continuing UK would approach negotiations in good faith and, in the interests of its citizens, would need to seek to ensure that a fair settlement applied to assets and liabilities (such as national debt).<sup>54</sup>*

- 5.17** However, the two governments appear to have differing views on when such discussions can take place. In the Scottish Government's White Paper, it is suggested that:

*It would assist in preparing for the negotiations if discussions between the governments were to take place prior to the referendum...<sup>55</sup>*

- 5.18** Whereas the UK Government position has been put forward by the Chief Secretary to the Treasury:

*The UK Government will continue to be one of Scotland's two governments and cannot enter into discussions that would require it to act solely in the interests of part of the UK over those of another part.*

- 5.19** It is also widely recognised that the negotiation process is unlikely to be straightforward, with a senior source in the UK Government being quoted as saying:

*The planned Independence Day of March 24, 2016, will not happen, leaving the current set-up as the 'default option', unless negotiations between Edinburgh and London are completed satisfactorily.<sup>56</sup>*

- 5.20** These negotiations will be linked to and influenced by other controversial factors which will need to be agreed, for example currency arrangements for an independent Scotland and EU membership. This has been illustrated by the recent debate over the Scottish Government's preference to retain the pound as part of a Sterling union,<sup>57</sup> and the UK Government's rejection of such a union,<sup>58</sup> which has resulted in speculation that the Scottish Government

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52. HM Government, *Scotland Analysis: Fiscal policy and sustainability*, 28 May 2014.

53. Scottish Government, *Scotland's Future: from the referendum to independence and a written constitution*, February 2013.

54. Scotland Office, *Scotland analysis: devolution and the implications of Scottish independence*, February 2013.

55. Scottish Government, White Paper, *Scotland's Future*, November 2013.

56. The Herald, *Yes might not mean Yes: 'smooth' iScotland talks still needed*, 14 February 2014.

57. As set out in the White Paper *Scotland's Future*, and *Currency choices for an independent Scotland*.

58. Chancellor on the prospect of a currency union with an independent Scotland, February 2014.

may not be liable for a share of the UK's national debt,<sup>59</sup> and the inclusion of a zero-share of debt being included in its latest figures.<sup>60</sup>

- 5.21** Such wider issues will also determine the extent of the financial management powers available to an independent Scottish Government. For example, entering into a currency union is likely to involve restrictions on fiscal and monetary powers available.
- 5.22** In the case of the proposed Sterling union, this would involve relinquishing control over monetary policy to the Bank of England, and would likely have to involve agreed limits on the level of borrowing which could be undertaken, similar to limits agreed for the European union.<sup>61</sup> Research has been conducted which considers the difficulties encountered in imposing fiscal limits.<sup>62</sup>
- 5.23** Therefore, the division of assets and liabilities between an independent Scotland and the remainder of the UK is likely to be a lengthy and complex political process. The outcome of these negotiations cannot be predicted, but whatever is agreed will determine the starting financial position of an independent Scotland.

## WHAT WOULD BE AN INDEPENDENT SCOTLAND'S LIKELY LEVEL OF PUBLIC SPENDING?

- 5.24** Using the most recently available figures, the UK Government estimate that identifiable expenditure on services in Scotland in 2012-13 was £54 billion,<sup>63</sup> whereas the Scottish Government figures show this to be £56 billion. This means there is a difference of around £2 billion in what the respective governments consider to be identifiable spending on services in Scotland.<sup>64</sup>
- 5.25** The Scottish Government also calculates figures for non-identifiable expenditure. This is an estimate of expenditure which benefits the UK as a whole, usually defence and debt interest.

59. Scottish Government, 'Devastating impact' of debt for rest of the UK, February 2014.

60. Scottish Government, *Outlook for Scotland's Public Finances and the Opportunities of Independence*, 28 May 2014.

61. As set out in the Stability and Growth Pact.

62. Victor Ngai, *Stability and Growth Pact and Fiscal Discipline in the Eurozone*, 4 May 2012.

63. Total identifiable spend under Scottish Parliament/Government control was 66% for 2012-13 (*Country and Regional Analysis: 2013*, November 2013, Table A.21: Identifiable expenditure on services for Scotland, Wales and Northern Ireland in 2011-12). When public spending is analysed on a territorial basis, most is 'identifiable' as being for the benefit of a particular region, eg on schools or hospitals. However, a small proportion is non-identifiable as it cannot be split up as it benefits the UK as a whole. This mainly relates to defence, foreign affairs and debt interest.

64. The Scottish Government's calculations of identifiable expenditure reflect the fact that in certain circumstances, officials in the Scottish Government believe a more accurate assessment of 'who benefits' is thought possible than is currently presented in the CRA. The principal changes relate to the treatment of expenditure on nuclear decommissioning by the UK Atomic Energy Authority, and the expenditure on the London Olympics. Further details can be found in *Government Expenditure and Revenue Scotland 2012-13*, March 2014.

This is currently estimated to be around £9.5 billion.<sup>65</sup> This means that an independent Scotland would be likely to spend in excess of £65 billion each year (based on 2012-13).

- 5.26 The year of proposed independence is 2016-17 and the Scottish Government<sup>66</sup> estimates that in that year total expenditure will be around £64 billion. However, this excludes payments for interest of a share of the national debt. When this is included the figure rises to between £67 billion to £69 billion (depending on how national debt is shared).<sup>67</sup>
- 5.27 Such apportionment of public spending is done on a purely statistical basis, and so gives only a broad picture of relative spending for the benefit of the different regions of the UK.

## WHAT WOULD BE AN INDEPENDENT SCOTLAND'S ESTIMATED TOTAL TAX REVENUE?

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- 5.28 Forecasts of future economic performance and tax revenues are also a defining factor in determining the future financial position of an independent Scotland and here we also see significant variations. A recent comparison of the projected forecast Scottish deficit for 2016-17, the proposed year of independence, illustrates a range of different results which can be gained, dependent on the underlying estimates and assumptions used (see table 2).
- 5.29 HMRC estimates that total tax revenues raised in Scotland in 2012-13 were between £38 billion and £42 billion (depending on whether this is calculated on a population or a geographic basis).<sup>68</sup> Scottish Government estimates of tax revenues raised suggest between £48 billion and £53 billion.<sup>69</sup>
- 5.30 Therefore, even when we consider the lowest estimates of spending on services and the highest estimates for tax revenues, we can see that there is still a shortfall of around £1 billion.

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65. When public spending is analysed on a territorial basis, most is 'identifiable' as being for the benefit of a particular region, eg on schools or hospitals. However, a small proportion is non-identifiable as it cannot be split up as it benefits the UK as a whole. This mainly relates to defence, foreign affairs and debt interest. The UK Government figures include only identifiable expenditure, whereas the Scottish Government figures also apportion a share of non-identifiable expenditure to Scotland. Together with slight differences in their calculations of identifiable expenditure this accounts for the differences in the figures quoted. Further information on the methodologies used can be found in [Country and Regional Analysis: 2013](#), November 2013 and Annex B of [Government Expenditure & Revenue Scotland 2012-13](#), March 2014.

66. Scottish Government, [Scotland's Future](#), 2013.

67. Scottish Government, [Government Expenditure & Revenue Scotland 2012-13](#), March 2014.

68. HMRC, [Disaggregation of HMRC tax receipts](#), March 2014.

69. [Government Expenditure & Revenue Scotland 2012-13](#), March 2014.

- 5.31 The only available forecasts for tax revenues in the proposed year of independence, 2016-17 have been produced by the Scottish Government. These estimates are £64 billion to £65 billion.<sup>70</sup> This further highlights the importance of financial reporting, in that the estimates above show considerable variation, partly due to the lack of information available on a Scotland-only basis. There are also differences between the UK and Scottish Government estimates, due to different treatments of some of the tax elements in their estimates.<sup>71</sup>

## WOULD TAX REVENUES RAISED BE ENOUGH TO SUPPORT PUBLIC SERVICES?

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- 5.32 In the proposed year of independence, 2016-17, assuming that Scotland does take a share of the national debt on independence, and using the highest estimate for both tax and spending, this still suggests a shortfall between income and spend of around £4 billion, or 6% of total spending.
- 5.33 A similar comparison of UK figures using the latest forecasts shows that in 2016-17 there would be a deficit of some £82 billion between expected tax revenues and total spending (11% of total spending).<sup>72</sup> Thus, the challenges facing an independent Scotland are not dissimilar to that of the UK in 2016-17 in that there is a forecast shortfall to be addressed.

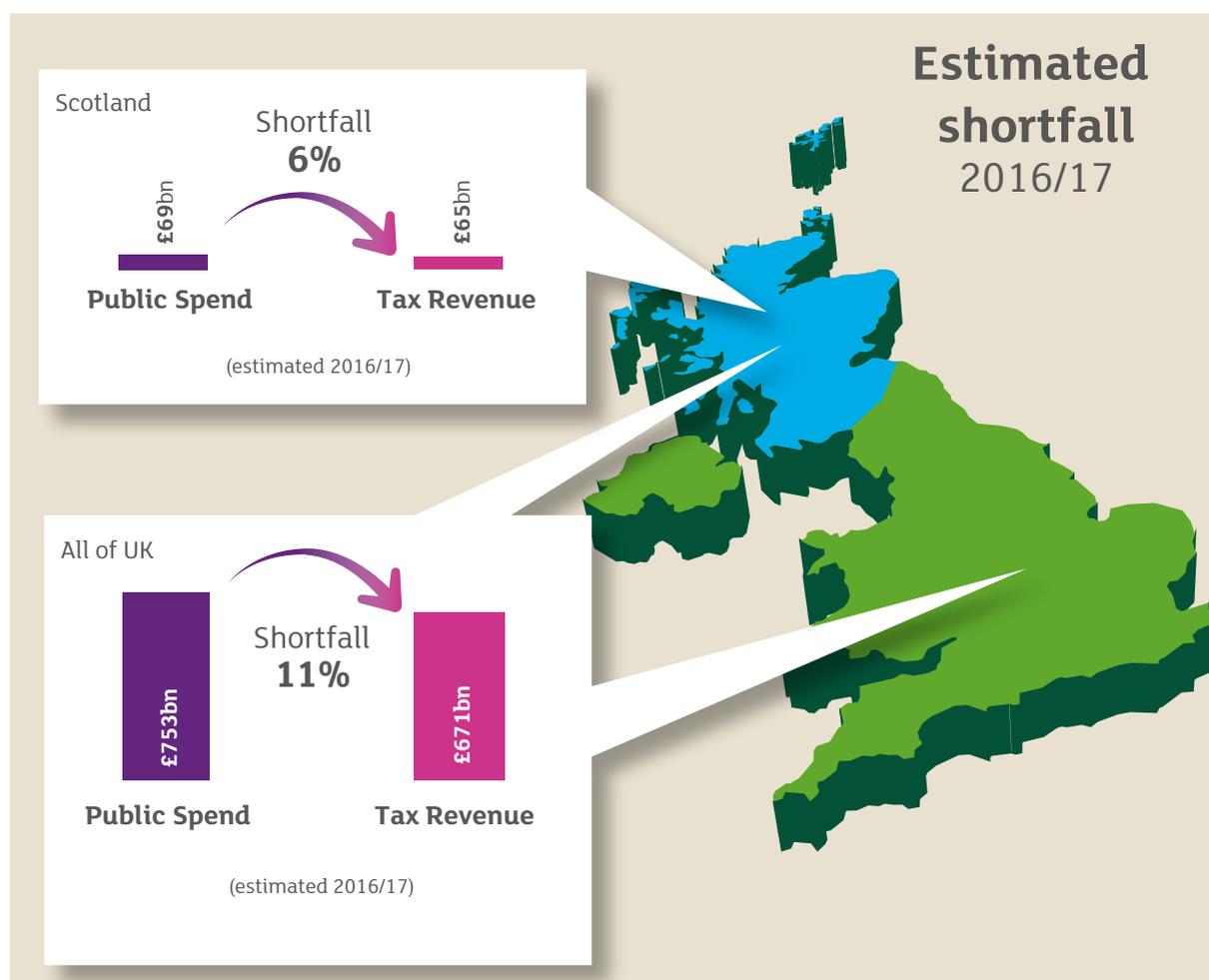
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70. Scottish Government, [Scotland's Future](#), November 2013.

71. This is further explained in a briefing for the Scottish Parliament, although it does not consider the most recent figures: SPICE, FSU Briefing, [Tax revenue estimates: a comparison of GERS and HMRC](#), October 2013.

72. Office for Budget Responsibility, [Economic and Fiscal Outlook](#), March 2014 (Chapter 4). Tax receipts of £671 billion and total managed expenditure of £753 billion forecast for 2016-17. Forecast tax receipts have been used rather than total income in order to make a similar comparison to the information available for Scotland, which is forecast tax revenues only.

Figure 7: Estimated shortfall, 2016-17



Source: CIPFA calculations from Scottish Government, *Scotland's Future*, November 2013 and OBR, *Economic and Fiscal Outlook*, March 2014

5.34 Of course, this is a necessary oversimplification of the financial position of an independent Scotland. Other factors must also be incorporated. For example, an independent Scottish Government would have greater levers with which to manage its financial and economic position. Examples of such levers would include the ability to borrow and to hold reserves to smooth funds over financial years, and the ability to develop Scottish policy on taxation and public spending. Other factors include economic performance and the associated volatility of tax revenues.

## OTHER FORECASTS FOR A SCOTTISH DEFICIT

5.35 Various commentators have forecast that the deficit of an independent Scotland in 2016-17 would be greater than that suggested by the Scottish Government of around £1,000 per head. As shown in the table below, most commentators suggest a deficit of closer to £1,700. This variance is mainly due to differing views on future levels of North Sea tax revenues.

**Table 2: Forecasts for the Scottish deficit in 2016-17**

Forecasting body	% GDP	£ billions	£ per head
Scottish Government	3.2	5.5	1,020
Centre for Public Policy for Regions (CPPR)	5.1	8.8	1,630
Institute for Fiscal Studies (IFS)	5.2	8.9	1,660
HM Treasury	5.3	9.1	1,690
Citi Group	5.4	9.3	1,720

Source: HM Government, *Summary of Forecasts of the Scottish Deficit in the Proposed Year of Independence*.

- 5.36 The figures above pre-date the latest OBR forecasts, which predict that UK borrowing will have reduced to £700 per person by 2016-17.<sup>73</sup> This suggests that an independent Scotland would have a deficit of around £1,000 per person.<sup>74</sup>
- 5.37 A major consideration in determining the financial position of an independent Scotland would be tax revenues from North Sea oil and gas. Regardless of how these assets are divided up, the levels of revenue collected in the future, and their volatility, would undoubtedly influence tax and policy decisions in an independent Scotland.
- 5.38 Again here we can see variance in forecasts and assumptions. In its most recent forecasts the Scottish Government presents four scenarios for future oil and gas tax receipts between 2014-15 and 2018-19, ranging from a total of £15.8 billion to £38.7 billion over this time.<sup>75</sup> In its recent analysis on the outlook for public finances in the event of independence, it uses scenario 4, which forecasts total offshore revenues of £34.3 billion.<sup>76</sup> In contrast to this, the most recent forecasts from the OBR<sup>77</sup> suggest a more cautious total of £17.6 billion over the same period, almost half the figure used by the Scottish Government in its analysis.
- 5.39 **CIPFA concludes:**
- **It is essential that the Scottish Government and the wider public sector can assure the public and other stakeholders of the sustainability of the public finances in the future regardless of the constitutional position. To do this, a different financial reporting regime will be required.**
  - **The starting financial position of an independent Scotland would be partly determined by the share of UK assets and liabilities it received. There are no clear rules for dividing assets and liabilities and this would be determined by a negotiation process. The opening position is as yet unknown.**

73. OBR, *Economic and Fiscal Outlook*, March 2014.

74. HM Government, *Scotland Analysis: Fiscal policy and sustainability*, 28 May 2014.

75. Scottish Government, *Oil and Gas Analytical Bulletin*, May 2014.

76. Scottish Government, *Outlook for Scotland's Public Finances and the Opportunities of Independence*, 28 May 2014.

77. OBR, *Economic and Fiscal Outlook*, March 2014.

- **Wider issues such as currency and membership of international bodies will also impact on the financial position of an independent Scotland and determine the financial levers available to manage the public finances.**
- **An independent Scotland would be likely to spend around £69 billion each year but forecasts for tax revenue suggest there will be a shortfall.**
- **Factors likely to impact significantly on the financial sustainability of an independent Scotland include North Sea revenues, the outcome of negotiations on the division of assets and liabilities, and the debt interest rate.**
- **Subject to the impact of these factors, an independent Scotland would face similar challenges to the rest of the UK in terms of financial sustainability going forwards. Although there may be challenges to be met, it would be for an independent Scottish Government to utilise the financial tools and levers available to it, to ensure that Scottish public services were affordable and sustainable for future generations.**

# If not Independence, Where To Next?

- 6.1** Further changes to the devolution settlement are already under way. In the event of a no vote, it is commonly agreed that the devolution process will continue,<sup>78</sup> and that this will almost certainly involve the transfer of further financial powers. This has led to speculation based on a range of terms, which mean little to the ordinary citizen, such as: devo-max, devo-more and indy-lite.
- 6.2** In the event that Scotland rejects independence, there have also been calls for a constitutional convention to consider the future of devolution across the whole of the UK.<sup>79</sup> All three Unionist parties in the Scottish Parliament support the strengthening of devolution and have presented their suggestions as to how devolution could evolve in the future. The leaders of the three opposition parties have issued a joint commitment to more powers in the event of a no vote in the referendum, particularly in relation to fiscal responsibility and social security.<sup>80</sup>

## POWERS FOR A PURPOSE

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- 6.3** The Scottish Labour Party established a Commission for Devolution to consider what further powers should be devolved in future. As well as further devolution to Scotland from the UK, this also looked at further devolution to local government. Launching the commission, Scottish Labour leader Johann Lamont said:
- Devolution can't just mean powers going from London to Edinburgh. That means a radical look at not just what powers should the Scottish Government have, but what powers does local government need, and which should be devolved further to local communities.<sup>81</sup>*
- 6.4** The commission's report<sup>82</sup> includes proposals for further financial devolution to Scotland, confirming it would give the Scottish Parliament the power to raise around 40% of its present budget from its own resources, some £2 billion more than powers to be transferred under the *Scotland Act 2012*. It proposes extending the 10p power over income tax rates to 15p and

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78. BBC News, *Scottish independence: 'No cross-party plan' on devolution*, February 2014.

79. House of Commons, *Political and Constitutional Reform – Fourth Report: Do we need a constitutional convention for the UK?*, March 2013.

80. BBC News, *Scottish independence: Pro-Union parties make pledge on Holyrood powers*, 16 June 2014.

81. BBC News, *Scottish Labour leader Lamont's new powers group meets for first time*, October 2012.

82. Scottish Labour Devolution Commission, *Powers for a purpose – Strengthening Accountability and Empowering People*, March 2014.

powers to vary the higher rates of income tax, but with safeguards to prevent competition with the rest of the UK in that the top rates could only be cut if all rates were reduced.

- 6.5 It suggests that some elements of welfare spending, including attendance allowance, the work programme (to be devolved to local government) and housing benefit are devolved, with pensions and other welfare benefits remaining reserved to the UK. It did not propose devolution of further taxes such as corporation tax, national insurance, VAT, capital gains tax or air passenger duty.

## HOME RULE AND A FEDERAL MODEL

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- 6.6 The Scottish Liberal Democrats established the Home Rule and Community Rule Commission, which has outlined its vision for '*home rule within a federal United Kingdom*'.<sup>83</sup> It defines such a federal system as one which '*allows for the expression of different identities within one system, but combines with it the additional influence and strength which comes from co-operation and common purpose*'. The commission calls for the Act of Union to be scrapped and replaced with a declaration of federalism.
- 6.7 In recommending a move towards fiscal federalism, the commission presents the case for Scotland to raise and spend most of its own taxes, with income tax being almost entirely devolved as well as the devolution of capital gains tax, inheritance tax, aggregates levy, air passenger duty and national insurance. Interestingly it does not call for the devolution of corporation tax, but rather that revenues of this tax raised in Scotland should be assigned for use in Scotland.
- 6.8 It proposes that the remaining funding required should come from a payment from the UK Government, but that this should be determined by a needs-based formula based on recommendations by an independent fiscal agency separate from the UK Treasury.

## THE STRATHCLYDE COMMISSION

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- 6.9 The Scottish Conservatives established the Commission on the Future Governance of Scotland (Strathclyde Commission) to look at how best to strengthen devolution and the accountability of the Scottish Parliament by examining its structures and extending its powers over taxation.
- 6.10 The commission's report sets out plans for further devolution to Scotland, including full powers over the setting of income tax rates and bands (but not personal allowances) and assignment of a share of VAT receipts. It also recommends devolution of some elements of welfare, such as housing benefit and attendance allowance.
- 6.11 The report calls for the establishment of a Scottish Fiscal Commission, as has recently been announced by the Scottish Government.<sup>84</sup> However, the Fiscal Commission to be established will initially be responsible only for evaluating the Scottish Government's tax forecasts, while this report recommends that such a commission should be responsible for producing official macroeconomic and fiscal forecasts in Scotland.

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83. [Federalism: the best future for Scotland – The report of the Home Rule and Community Rule Commission of the Scottish Liberal Democrats](#), October 2012.

84. Scottish Government, [Scottish Fiscal Commission announced](#), 7 May 2014.

- 6.12** Together with these further powers, the report also calls for a range of reforms in the Scottish Parliament, primarily to strengthen legislative scrutiny. It also recommends the formation of a committee representing all the UK legislatures to be created to shape the future of the UK and to improve relations between the various parliaments and assemblies throughout the Union.

## MANAGING FURTHER FINANCIAL DEVOLUTION

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- 6.13** In the event of further financial devolution, regardless of what shape this takes, it is crucial that greater financial powers are utilised to support strong financial management of the public finances.

**6.14 CIPFA concludes:**

- **All three Unionist parties in the Scottish Parliament support further devolution in some manner, and have issued a joint commitment on further devolution of fiscal and welfare powers.**
- **Such powers should also come with additional flexibilities to allow for better management of the public finances across financial years.**
- **This means there will be a different fiscal future for Scotland, whatever the outcome for this referendum.**
- **There is opportunity to develop an improved financial management control and reporting framework which supports Scotland's decision-makers while enabling accountability.**

