The
Sustainable
Growth
Commission

Scotland – the new case for optimism

A strategy for inter-generational economic renaissance

The report of the Sustainable Growth Commission

May 2018

“Until one is committed, there is hesitancy, the chance to draw back, always ineffectiveness. Concerning all acts of initiative (and creation), there is one elementary truth, the ignorance of which kills countless ideas and splendid plans: that the moment one definitely commits oneself, then Providence moves too. All sorts of things occur to help one that would never otherwise have occurred. A whole stream of events issues from the decision, raising in one's favour all manner of unforeseen incidents and meetings and material assistance, which no man could have dreamt would have come his way. I have learned a deep respect for one of Goethe's couplets:
Whatever you can do, or dream you can, begin it.
Boldness has genius, power, and magic in it!”

William Hutchison Murray 1913-1996

“The difference between what we do and what we are capable of doing would suffice to solve most of the world's problems”.

Mohandas Karamchand Gandhi 1869-1948

The Sustainable Growth Commission

1 ABOUT THE SUSTAINABLE GROWTH COMMISSION

1.1 The Sustainable Growth Commission was established by the First Minister and Scottish National Party (SNP) leader, Nicola Sturgeon, in September 2016. The membership of the commission was at her invitation under the Chairmanship of Andrew Wilson. It has approached its remit through commissioned research, the insights and analysis of its members and through a series of meetings with economically important organisations across Scotland and from independently offered advice and analysis. Its members served pro-bono and its budget was entirely funded by the Scottish National Party.

Remit

1.2 To assess projections for Scotland's economy and public finances, consider the implications for our economy and finances under different potential governance scenarios, and make recommendations for policy on:

- Measures to boost economic growth and improve Scotland's public finances - both now in the aftermath of the EU referendum and in the context of independence
- The potential for and best use of savings from UK programmes in the event of independence, such as Trident
- The range of transitional cost and benefits associated with independence and arrangements for dealing with future revenue windfalls, including future North Sea revenues.

1.3 In addition, the Commission was asked to take account of the recommendations of the 2013 Fiscal Commission reports, and the outcome of the EU referendum, and consider the most appropriate monetary policy arrangements to underpin a programme for sustainable growth in an independent Scotland.

Commission Members

1.4 The Commission membership includes senior figures from business, economics, politics and academia and has also drawn on externally commissioned research and expertise.

1.5 Members of the Commission take part in a personal capacity and membership of the Commission does not indicate support or membership of the SNP. Membership of the Sustainable Growth Commission:

- Cllr Marie Burns, Shadow Economy and Communities spokesperson, North Ayrshire Council

- Iain Docherty, Professor of Public Policy and Governance, University of Glasgow
- Kate Forbes, MSP for Skye, Lochaber and Badenoch
- Andrew Hughes Hallett, Professor of Economics and Public Policy, George Mason University and University of St Andrews
- Dan McDonald, businessman and founder of N56 group
- Derek MacKay MSP, Scottish Government Cabinet Secretary for Finance
- Marie Macklin CBE, Founder and Chief Executive of the Klin Group and Macklin Enterprise Partnership
- Jim Mather, former Enterprise Minister and Visiting Professor at the University of Strathclyde and Heriot Watt University
- Roger Mullin, Honorary Professor at University of Stirling Management School, former MP and SNP Westminster Finance spokesperson
- Catherine Schenk, Professor of Economic and Social History, University of Oxford
- Mark Shaw, Chief Executive, Hazeldene Group
- Shirley-Anne Somerville, Minister for Further Education, Higher Education and Science
- Petra Wetzel, founder and Managing Director WEST Brewery
- Andrew Wilson (Chair), Founding Partner, Charlotte St Partners

1.6 Research and logistical support has been provided by Graeme Blackett, Director of BiGGAR Economics. The coordination and organisation of the consultation and engagement programme was undertaken by Ian McAllan.

1.7 We are extremely grateful to Graeme Blackett and his team at BiGGAR Economics for their work supporting the Commission. We are also very grateful to David Skilling of Landfall Strategy Group, John McLaren (Scottish Trends) and Richard Marsh of 4-consulting and Professor Patrick Dunleavy of the London School of Economics for their work supporting some of the insights in the reports.

1.8 A number of other individuals offered personal insight, analysis and criticism throughout the process and they are too numerous to mention. All and every point made has been considered very carefully. We are especially grateful to our three senior Peer Reviewers who devoted very valuable time to offer very material improving comments and generally very supportive perspectives on the direction taken.

1.9 The data and evidence are sourced throughout the three sections of the report. All data is subject to update and revision but the data referenced was the most recent and comprehensive at the time of writing. During the course of the Commission's work, it has been necessary to update the analysis as new data has been published and it has been notable that the updates did not change the conclusions and recommendations reached. The analysis is based on an examination of the long-term performance and prospects of the Scottish economy and while monthly, quarterly or annual data releases do provide some insights, the focus of debate and energy should be on improving the long-term trajectory.

1.10 Finally, we are, of course, very grateful to the First Minister whose initiative this Commission is and who has offered all of us an historic opportunity to make a public service contribution to Scotland's policy debate. While we have briefed the First Minister and her colleagues as the research and analysis work has been undertaken, the content of this report is entirely the responsibility of the Commission and its members.

1.11 The content of this report is entirely the position of the Commission itself and should not be seen as necessarily reflecting the rounded views of any individual that has contributed commissioned work.

Engagement Process

1.12 At the first meeting of the Sustainable Growth Commission, one of the first suggestions made was that it was necessary to engage with a wide range of interests to gather views on what was required to improve performance. It was swiftly agreed that the Commission needed to consult as widely as time and resources would allow, so that the recommendations reflected not just the views of the Commission members, but a wide range of ideas from the sectors that make up the Scottish economy.

1.13 Many of the suggestions made during the engagement exercise have been discussed in the Commission's report and ideas that emerged became the subject of more detailed research.

1.14 Of the 23 organisations contacted, only Scottish Financial Enterprise declined a meeting so for this sector direct company engagement was undertaken. Oil & Gas UK, due to other unanticipated commitments on the day of the meeting, provided a written submission. The meetings and dates were as follows:

- Scottish Tourism Alliance (22.11.16)
- Scottish Engineering (23.11.16)
- Scotland-IS (24.11.16)
- Scottish Life Sciences (28.11.16)

- Scottish Renewables (29.11.16)
- Scottish Council for Development & Industry (2.12.16)
- CBI Scotland (5.12.16)
- Universities Scotland (6.12.16)
- Institute of Directors (7.12.16)
- Federation of Small Business (13.12.16)
- Entrepreneurial Scotland (14.12.16)
- Business for Scotland (20.12.16)
- Social Enterprise Scotland (21.2.17)
- Chemical Sciences Scotland (2.3.17)
- Scottish Chamber of Commerce (7.3.17)
- Technology Scotland (9.3.17)
- Scottish Council for Voluntary Organisations (21.3.17)
- Scottish Food & Drink (17.3.17)
- Scottish Property Federation (21.3.17)
- Law Society of Scotland (11.4.17)
- Royal Society of Edinburgh, Business Innovation Forum (15.1.18).

1.15 The meetings were facilitated by at least two Commission members, (or the chair individually), with the numbers of organisation members in attendance ranging from three to twenty. The meetings were conducted under Chatham House rules.

1.16 The meetings were welcomed by those who took part, as an opportunity to consider what the future aspirations for the Scottish economy should be, where the opportunities are, what the constraints might be and what needs to change to improve performance.

1.17 It is anticipated that the report will provide the basis for further engagement and debate with all of those interested in shaping the best possible policy framework for Scotland, irrespective of their positions on whether or not Scotland should be an independent country. Indeed, we hope that much of the work we have produced could be of value to the debate on governing Scotland in advance of any future independence choice.

The Sustainable Growth Commission

2 INTRODUCTION BY ANDREW WILSON, CHAIR

2.1 It has been a privilege for me to chair the Sustainable Growth Commission and I thank the First Minister, sincerely, for the opportunity.

2.2 The process of producing this report has made me believe more than ever, that independence is the best option for Scotland's future. By this I mean a country which has as much responsibility as possible for its own government while choosing to pool, share and co-operate with its partners across the rest of the UK and Ireland, Europe and internationally.

2.3 This is not based on any unwavering certainty or 'fundamentalism' on my part. Very few things in life are certain. As Richard Holloway has argued, "the opposite of faith is not doubt, it is certainty"[1]. I constantly challenge and am challenged in what I believe to be true. However having revisited every assumption, belief and opinion I have held to date in the production of this work, my faith in Scotland's future potential as a normal independent country is resilient. I have always felt that Scotland's 'journey begun long ago, and which has no end"[2] could only ever progress at the pace of a rational and questioning people. I recognise the challenges to many of each step on this journey not least because of a strong sense of British identity, which I, for one, share. We must seek to maintain a respectful dialogue of gentle persuasion at all times to find the greatest possible consensus behind each forward step we take.

2.4 This report seeks to provide a strategy for the future to assist the people who choose to make their lives in Scotland to determine the best route forward for our economy and society.

2.5 It is important that independence must never be seen as a magic wand or quick and easy step to success. Indeed, there is no pot of gold, black or otherwise, at the foot of the independence rainbow. But there is a toolbox and using it will mean taking responsibility for choices that seek to create a stronger economy, sustainable public finances and a fairer society. Independence is a means to those ends, I believe a necessary but not sufficient step to success. The choices that are then made about the country's strategy and how effectively they are delivered are what will determine success – we are our choices.

2.6 While that was true in 2014, lessons have to be learned both from the experience of that referendum and the events that have unfolded since. This means clear sighted analysis of the prospectus for independence and also, of the 'status quo'. Of course, it is no longer a status quo, not least because the UK is now following a path to exit the European Union

[1] Richard Holloway: Interview with Bryan Appleyard, The Sunday Times, 11 March 2012
[2] Donald Dewar, speech at the opening of the Scottish Parliament, 1st July 1999

that the Scottish people did not choose. We judge that this path threatens material and lasting damage to our economy and therefore society, limiting the opportunities of future generations

2.7 This report focuses on challenges as well as opportunities. We must be candid about those challenges as well as optimistic about the opportunities. If people are to be persuaded of the case for independence, including reconvincing many of those who voted 'Yes' in 2014, they must be confident that the challenges are not being glossed over or minimised, but that there is a plan in place to address them. Hope must conquer fear, of course, but that hope needs to be grounded in clear-sighted reality and a rigorous plan. And in putting this together in this report, we have drawn on the best expertise we could find; Scotland, we think, has not had enough of experts.

2.8 This report argues that Scotland has an economic potential that far outstrips its current and longer-term performance. The ambition for the country should be to perform to the best of the small advanced economies in the world and in doing so make choices about the sort of society and economy we wish to live in. Bridging the gap between potential and performance is the purpose of this report.

2.9 To achieve this will mean challenging the way that all sides in our national debate approach the challenges and opportunities, and one another. Purposeful action must commence immediately and will quickly begin to reap rewards. But that action must be long term, inter-generational and cross partisan.

2.10 Whatever one's perspective on the constitutional position of Scotland, the UK and Europe, there should be a shared desire to achieve the full potential of the country. Our current performance and position is not 'as good as it gets' and we can, collectively, do so much better.

2.11 Our work represents the output of over 18 months of analysis and deliberation by the Sustainable Growth Commission. Our method has drawn on commissioned research and analysis from a range of experts and in particular an analysis of the best lessons from a benchmark group of 12 small advanced economies. From these lessons we make clear recommendations for action on growth, stewardship of the public finances and our future currency and regulatory position.

2.12 In summary we contend that:

(1) We can lift the growth performance of the country to take living standards to equal the best small countries in the world over a generation;

(2) Our public finances can be put right sustainably from the unsustainable position we inherit from the UK system at present. And we can do so in a way that continues to grow public spending while stewarding the growth position of the economy;

(3) In terms of currency and regulation the transition through independence to a new Scottish system can be managed in an orderly fashion which maximises stability and contains risks to jobs and investment very effectively. Future choices on currency could be considered and earned, on terms that are made clear up front, once the economy and public finances are on track to the sustainable high-performance position our ambitions require.

The report sets out how independence would give us opportunities to, for example:

- tailor policies to suit our own needs and economic characteristics, grow our population and lift our performance closer to that of other small advanced economies;
- move away from the unsustainable levels of deficit and debt created by UK economic management towards a sustainable position more in line with international standards and comparable countries - but in a way and at a pace that allows us to protect public services and grow the economy;
- ensure that areas of spending funded through our taxes but currently controlled at Westminster, for example social security, can more effectively tackle poverty and inequality;
- better align spending on defence with Scotland's size and circumstances;
- ensure that spending on public administration and infrastructure benefits the Scottish economy;
- determine the monetary arrangements that best suit our needs, not just in the short to medium term when stability and continuity may be the priority, but over the longer term too;
- forge and maintain our own international relationships to maximise trade, not just across our own islands, but across Europe and the rest of the world too.

2.13 Taken together it represents the most substantially resourced policy effort on the Scottish economy and independence undertaken to date. It is our hope that the content of this report justifies the time, resource and effort that has gone into it and the faith placed in the Commission by the First Minister.

2.14 Throughout the report, 2021/22 is used as a baseline year. It must be stressed that this is purely illustrative. Self-evidently, it is not for this Commission to predict when Scotland might become independent nor is this choice a signal of any intent on the part of the SNP or Scottish Government. It also follows that any numbers that flow from this baseline are also illustrative. What is important about this report are the principles and approaches to fiscal management and economic growth that it recommends - these remain relevant whatever the starting point.

2.15 This report provides analysis and makes recommendations to aid policy development. It is now up to the policy makers to consider it. In the first instance, it is for the SNP which commissioned the report to consider it through its normal processes. I hope it is also of use and interest to the wider independence movement. Indeed, I chiefly hope that it will provide food for thought for those who do not favour independence, we hope that many aspects of all three parts contain positions that can be agreed across the political spectrum.

2.16 We know that not every detail will win the immediate support of all sides in the debate or even of everyone who already supports independence. That is inevitable and is not something we have shied away from. A point that was perhaps not always fully grasped in 2014 is that choosing independence does not mean signing up to every detail of a specific future policy prospectus in advance.

2.17 However, I think the report represents, for the first time, a systemic consideration of every part of the economic prospectus and seeks to connect major choices on matters on currency, public finances and, of course, economic growth. In doing so we judge that it represents the best possible route to achieving a sustainably successful economy and cohesive society.

2.18 It also represents a prospectus that recognises the transitions that are required between the inherited starting point and the creation of the sort of country we seek to be. A clear sighted and honest exposition of how to make this transition orderly is the very least that should be expected by those we seek to convince.

2.19 Moreover, it is also possible that many of our recommendations could be agreed and implemented in advance of independence either with existing or enhanced policy responsibilities for Scotland's Parliament and Government.

2.20 The aspiration of everyone should be to raise our growth and living standards to the level of the best performing economies. All policy recommendations should be judged against their ability to deliver this. The economic model and strategy that is selected could take any one of many forms currently working successfully around the world. But we must also be very mindful of the structure of the economy and society that we start with and learn every possible lesson that the realities of history have to teach us.

2.21 We recommend a 'Next Generation Economic Model for Scotland', designed to achieve cross-partisan support, which learns in particular from Denmark, Finland and New Zealand. The point though is to adopt and tailor a model for Scotland's unique challenges and opportunities.

2.22 We should maintain a keen and intelligent eye on the experience of other countries and work hard to bring that inspiration and evidence to bear on our own thinking and tailor our policy to our own unique conditions. We also have to keep pace with the reality of a fast-moving international trading and economic environment.

2.23 The real challenge we provide to many who currently do not support independence or enhanced policy control for Scotland, is that we believe that the current UK model is not sustainable. Taken together with the UK's approach to exiting the European Union, this represents a material risk to living standards in Scotland in the short, medium and long term.

2.24 What is undoubtedly the case, is that the current era represents a fundamental challenge to the global system in which the role of government itself is under scrutiny and reform is underway. While globalisation has improved the overall welfare of the world it is also true that the benefits have not been adequately shared. The health of the economy, in its simplest measure, boils down to the sum of all wages and salaries and all of the profits. The fruits of this are now unevenly spread by geography, gender and generation and in many other respects.

2.25 Partnership is needed to ensure that our strategic approach is cross partisan, inter-generational and purposeful. This will mean government, business, trade unions and wider civic society working on concert.

2.26 Considering the best way forward for Scotland in the face of all opportunity and challenge requires trade-offs to be considered and choices made. An honest exposition of what these are will benefit the quality of the debate and ultimately the sustainability of the choices we then make.

2.27 In the very simplest terms we can recognise a number of trade-offs implicit and explicit in the framing of the current debate which we contend require consideration and reframing. Some argue, for instance, that the estimated Scottish public finance deficit within the current system is an imperative to stay the same and renders a distinct autonomous approach impossible and unaffordable. In this report, we argue the opposite, that it is the very evidence of the reason for reform and that controlling how it is put right is far more preferable to having it done to us. Indeed Brexit, and in particular a hard Brexit, is likely to depress tax revenues and squeeze public spending across the UK.

2.28 Similarly, some effectively argue that lower growth within the limited large country model of the UK system is a price worth paying for the security and 'certainty' of the funding of the fiscal deficit. We disagree, fundamentally, and argue that purposeful effort to improve the growth performance and consolidate the public finances is a far more sustainable approach as the lessons of the best performing small countries suggest. Not least because Brexit and political decisions at Westminster mean there is no security or "certainty" at all that Scotland's deficit will continue to be funded. But, also because that policy and approach is not producing anything like the potential outcome for the economy, living standards or social cohesion. The evidence demonstrates that smaller countries, partly because of their greater need to respond to global challenges, produce better governance, policy and therefore living standards.

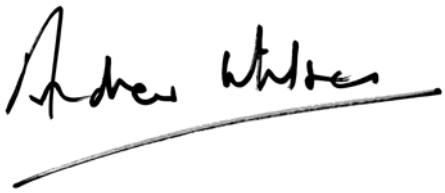
2.29 Having a purposeful and clear point of view is critical to the leadership of the economic policy agenda. We must choose and make good our choices. Those choices must mean taking responsibility for the society and economy we create now and pass on to the next generation. It is for all of us who believe in the potential for a better country to inspire

people behind this message of empowerment – not as an easy option that will make challenges magically disappear, but as the best way to address these challenges and bridge the gap between our performance and potential.

2.30 Carrying on as we are now would represent a dereliction of our duty to both our own potential and that of the generations to follow whatever the constitutional choices we make.

2.31 What must be beyond doubt for all sides in the debate is that Scotland has the experience and skill to navigate the current climate and any independence process as well as any of the 193 current members of the United Nations.

2.32 We would start an independence transition with greater information certainty and existing institutions and competences than any other country that has ever made the choice. The conditions for success exist. Whether we choose to take the opportunity is a matter, as always, for the people who have made their lives here, to choose.



Andrew Wilson
Edinburgh, May 2018

The Sustainable Growth Commission

3 SUMMARY

Part A: Raising the Potential and Performance of the Scottish Economy

3.1 Part A of the report considers the performance of the Scottish economy, set in the context of the global and UK economy and assesses the potential for improvement. This is done by drawing on the experience of the peer group of the 12 most successful small advanced economies and assessing the lessons that can be learned to make the most of Scotland's potential. This sets out some principles for a new Scottish economic model and long-term policy strategy. It then proposes a framework for a Scottish economy that is designed to match the performance of the benchmark small advanced economies. Based on that framework, a series of policy recommendations to support these growth aspirations now and with fuller policy powers are set out.

3.2 The approach is to grow GDP by focussing variously on productivity, population and participation (inclusive) growth – the three 'Ps" of economic performance. The focus on productivity is very important and has dominated much of the economic debate in recent years. However, we recommend an elevation of focus on population growth and participation as critical to short term demand as well as to the longer term health and well-being of our society.

3.3 To consider all of this we look at the evidence from the performance of the UK economy over recent decades, the approach and performance of our benchmark group of small advanced economies, and the underlying assets and strengths of Scotland and therefore its potential.

3.4 Our central argument is that Scotland should be seeking to emulate the performance of the best small countries in the world, rather than sticking to its current position as the best of the rest of the UK regions and nations outside of the south east of England.

3.5 We strongly believe that the balance of UK ambition and policy intervention in recent decades has been significantly to the disadvantage of both Scotland and the UK economy as a whole. The centralised 'big country' model which concentrates too much economic activity in London and the South-East region is holding Scotland and the other regions and nations of the UK below their potential. Some argue that this is a price worth paying if fiscal transfers take place as compensation. We fundamentally disagree.

3.6 Brexit is a clear and present danger. In the short-term, Scottish interests would be promoted by proper engagement between the UK Government agreeing to proper engagement with

the Scottish Government and a respect for the different perspective of the Scottish population and the acute requirements of the Scottish economy.

3.7 We hope that this report helps to articulate an approach and way of thinking that then allows others across the policy debate to frame their ideas and contributions.

3.8 We have, quite purposefully, not yet tackled some of the other very substantial reform challenges that face economies everywhere that deserve to be the subject of detailed and focussed analysis. In particular the impact of artificial intelligence, automation and further technological advances merit a substantial national review and debate in and of themselves. Policymakers and leaders must think ahead to the sort of society and economy we will become and the implications of that for everything from education strategy to inequality and the overall role of government itself. Room needs to be found in the Scottish and UK discourse for such deeper and longer-term themes to be aired.

3.9 What is clear from the evidence of the most successful countries is that having a strategic approach that is unambiguous and agreed for longer term effort (as far as is possible) and cross-partisan (as far as possible), is a huge advantage. Partnership is needed between government, business, trade unions and wider civic society to ensure policy can be made sustainable. Economic success is built long term, over generations by sustained effort, close attention to evidence and feedback and clever agile short-term policy responding to prevailing economic conditions and competition.

3.10 None of the most successful countries that we have examined have underlying advantages over Scotland that suggest our aspiration to equal or exceed their performance is unreasonable. In fact, Scotland has many advantages that set the country apart in economic potential.

3.11 What is certainly true, however, is that the structure of Scotland's economy and society has not yet adequately transitioned from the fall-out of post war industrial restructuring, especially in the 1980s. This renders significant challenges for policymakers balancing the calls on limited resources for measures to alleviate the symptoms of underperformance, against calls for other measures to grow the scale and performance of the economy in a way that will tackle those symptoms at source. The pressures this has placed between and within generations, on demographic groups and regions are considerable. Enabling policymakers and those that hold them to account to take risks, act purposefully and elevate the long term national self-interest, is extremely important.

3.12 This report is by no means the last word on ideas for strategies and policies for growth, far from it. There are numerous such reports and policy ideas to draw on. We especially commend the report by Lord Heseltine "No stone unturned in pursuit of growth" for the

UK Government in October 2012. It included a rational critique of the UK model and many positive recommendations that have gone apparently unheeded.

3.13 What we have therefore sought to do is provide a comprehensive attempt to learn the best lessons from the best performing countries and put that into a framework that is accessible, useful and useable by all. We make a series of specific recommendations and urge all participants in the economy and economic policy debate to engage positively.

3.14 What is clear is that there are no silver bullets or cleverly designed or as yet undiscovered routes to success. The key lesson amongst all is the need to think and act for the long term; frame a strategy and deliver to it.

3.15 Ultimately this is about the sort of country – society and economy – we want to become and believe that we can become. If many other small countries have succeeded, why not Scotland?

3.16 It is also important to consider all factors when assessing the true quality of life in a country. The relative cost of housing, quality of public services, amenity and culture all matter hugely. How we choose to live, behave and conduct ourselves define the country far more than the numbers. But that is for a broader debate that we hope the foundations provided by the work of the Commission can provide a basis for.

3.17 Ultimately all of the choices we face represent trade-offs. In this part of our report the evidence suggests that the best performing countries are aware of the need to respond to changes in the global economy but as a result have better governance and policymaking that produces better average growth and therefore living standards. Small economies perform better than larger ones consistently by around 0.7 percentage points per year over the last 25 years on average.

3.18 We hope that the ambition to be among the very best in the world is one on which all sides in Scotland's debate can agree. Carrying on as we are now is unlikely to achieve this. The onus on all sides in the policy debate is therefore to accept the burden of proof lies with all sides. We have accepted our responsibilities in that regard with enthusiasm.

Key Points by Chapter: Part A

Economic Context

3.19 Scotland is without question a rich and successful nation, in the top 25 of global economies in terms of income per head and ranks near the top in the UK on most long-term indicators.

3.20 Scotland has very significant comparative economic assets and advantages, in terms of natural resources, the education and skills of the people who live in Scotland and sectors with existing and potential global competitiveness.

3.21 It is energy-rich with oil and gas resources, up to 25 per cent of Europe's tidal power potential and 25 per cent of Europe's offshore wind potential.

3.22 We have world-class universities, a world-wide reputation for premium food and drink products and our country has been named the world's most beautiful, boosting our outstanding tourism industry. We are at the cutting edge of games technology, photonics, life sciences, advanced manufacturing and other industries of the future.

3.23 Despite these abundant resources, other independent countries with the ability to tailor economic policy to their own needs have performed better than Scotland. The median income of the group of 12 small advanced economies[3] is 14% higher in GDP per head; a gap of £4,100 per person. This shows what is possible for an independent Scotland.

The UK Economy Before Brexit

3.24 The economic debate was at the heart of the 2014 referendum[4]. That debate was predicated on the assumption that the UK would continue to be a member state of the EU.

3.25 A key argument from the pro-independence side was that the UK economy was unusually unbalanced – both in terms of geographical performance and inequality in income and wealth among UK citizens.

3.26 This report shows very significant regional disparity of performance in the UK. The gap in performance by local areas is by a distance the most unequal in Europe, with far too much economic activity and opportunity concentrated in London and the South-East of England.

3.27 The gap between rich and poor in the UK continues to be one of the largest among developed countries, with growing evidence that such inequality acts as a drag on economic performance.

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[3] The reference group of 12 small advanced economies consists of Austria, Belgium, Denmark, Finland, Hong Kong, Ireland, the Netherlands, New Zealand, Norway, Singapore, Sweden, and Switzerland

[4] Reports published included the UK Government's Scotland Analysis Papers; Scotland's Future, the White Paper published by the Scottish Government and other papers such as Building Security and Creating Opportunity: Economic Policy Choices in an Independent Scotland, published by the Scottish Government in 2013.

3.28 A dependence on consumer debt fuelled spending for growth has been a consistent feature of the UK economy, is not sustainable and carries very significant risks.

3.29 The UK's export performance has been poor and with a falling share of the global market. The UK has – by far – the highest trade deficit in the EU.

3.30 Scotland performs close to the UK average in terms of economic performance per person but has not enjoyed similar levels of population and labour force growth.

3.31 If Scotland had matched UK population growth since 1980, the population of Scotland would now be 5.8 million, if it had matched the population growth of the other small European countries (such as Austria, Denmark, Finland, Ireland, Norway and Switzerland) there would be 6.1 million living in Scotland.

Brexit – Two Futures

3.32 If the gap between Scotland's real per capita income and the median of the small advanced economy group was closed, income per head would be 14 per cent higher. Closing the gap between Scotland and the best performers would increase incomes by half. Closing this gap would mean, in today's values, an additional £22 billion in additional GDP and a potential additional £9 billion in tax revenues.

3.33 The decision of the UK to leave the European Union will fundamentally change Scotland's economic future. Brexit will almost certainly widen, not narrow, the gap between Scotland and comparator countries.

3.34 The UK Treasury says Brexit will make the UK "permanently poorer". This is not a controversial claim. There is a widespread consensus among economists, with few exceptions, that leaving the EU will damage UK economic growth, productivity and job creation.

3.35 The Fraser of Allander Institute estimate a potential Brexit impact of the loss of between 30,000 and 80,000 jobs, the loss of between £3 billion and £8 billion in GDP and a real wages cut of £2,000, depending on the model that succeeds Brexit negotiations.

3.36 Scottish Government modelling shows an adverse impact on trade, productivity, population and foreign direct investment. And LSE's Programme of Brexit research suggests Scotland (as well as Wales and Northern Ireland) are already being disproportionately hit by the impact of the Brexit vote.

3.37 The already huge difference in economic performance between London and the South-East of England and other parts of the UK is therefore likely to increase.

3.38 This means it is essential to stimulate an inclusive, national debate on Scotland's economic future to find out whether a different, better path is possible.

3.39 Scotland's resources and talent, combined with good decision-making and the ability to tailor policy to our needs, can lead to improved economic performance and avoidance of the low growth future in a UK outside the EU. The growth aspirations here are structured over three time-horizons: (i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.

3.40 The long-term nature of the strategy should not diminish its urgency. It must begin now.

Insights on the Performance of Small Advanced Economies

3.41 Common themes in benchmark small advanced economies policy include a commitment to strong policy foundations (solid macro policy settings, innovation and human capital, and internationalisation), as well as a high degree of strategic coherence across these different policy settings, positioning the country to compete effectively in the global economy.

3.42 Small economies perform better than larger ones consistently by around 0.7 percentage points per year over the last 25 years on average.

3.43 This growth performance has meant the benchmark group of 12 small advanced economies has held its share of the global economy over past decades remaining competitive even with the integration of the large emerging markets. The share of many large economies, including the UK, has retreated substantially.

3.44 Small advanced economies have done well in terms of labour market performance, with relatively low unemployment, on average, a couple of percentage points under those of larger advanced economies.

3.45 On average, there is no clear margin between small and large advanced economies in terms of levels of labour productivity which is constrained in small economies by the small size of the domestic market; however the strong performance in the trading sectors offsets this. In this respect leaving the EU and Single Market would obviously act as a growth restraint for Scotland.

3.46 Small advanced economies also tend to do well on measures of the extent to which the gains from growth are broadly shared. Many small advanced economies, notably those in Northern Europe, have low levels of income inequality. Income distribution outcomes are

a matter of long term policy choice and effective implementation, rather than anything intrinsic to small advanced economies.

3.47 The overall performance of our benchmark group is significantly ahead of the UK and the large economies. Policy making is more agile and of higher quality because it requires to be.

3.48 Through history, there has been a strong relationship between periods of trade openness and an increase in the number of countries. Over the past 100 years, the number of independent countries rose from under 70 to just under 200 today.

3.49 Overall, small countries have effective, responsive governments, with a well-developed sense of strategic capacity, high levels of trust and social cohesion, and the ability to adapt in response to changing international circumstances.

3.50 Small competitively-strong economies are continuing to invest in key sectors and clusters, to help them develop positions of advantage in a more competitive and challenging global economy.

3.51 The levels of international engagement by small advanced economies are substantially higher than for larger economies and the growth in international economic activity has also been stronger. This is the case for both exporting as well as cross-border direct investment.

3.52 Large multinational firms play an important role in small advanced economies in driving international expansion.

3.53 However, increasingly, small advanced economies are investing in firm-level enterprise policy to support international expansion by indigenous firms. Export promotion agencies are increasingly working intensively with high-growth potential firms to accelerate their international engagement.

3.54 Small advanced economies take micro and macro policy foundations very seriously. Small advanced economies rank highly on the various indexes of the quality of policy and flexibility of business environment.

3.55 The strong performance of small countries is largely a matter of deliberate choice and management. It is the small advanced economies that have positioned themselves most appropriately for the challenges and opportunities of globalisation that have performed best. In contrast, those countries that did not engage with, and respond to, these global forces did not fare well.

3.56 Two fundamental lessons are clear: Scotland must become more engaged, not less, in the global and European economy in order to boost growth. And the opportunity to contribute to, and benefit from, that growth must be more widely shared.

3.57 In considering the future, the UK economic model is wrong for Scotland. Leaving the EU and the Single Market, hostility to immigration, concentrating economic activity in London and the South-East of England, low wages and tolerating a large gap between rich and poor can only depress growth and opportunity.

3.58 Our recommended starting point for a *Next Generation Economic Model* for Scotland is based on learning the lessons from small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. Drawing on all 12 small advanced economy case studies we are especially drawn to a hybrid of Denmark, Finland and New Zealand. Features of that model include; quality of governance; long term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location, placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective. The best of the lessons of Denmark, Finland and New Zealand are at the heart of this but many other countries can, of course, offer continued inspiration.

The imperative of population growth

3.59 Scotland has recently been transformed from a nation suffering from population decline to a country benefitting from net immigration for the first time in our recent history. Positioning ourselves with an outward focus will both increase opportunities for the next generation of Scots born here and ensure we continue to attract talent.

3.60 Given the demographic structure of Scotland, migration is critically important to population growth and also productivity performance. IMF evidence suggests a 1 per cent increase in the share of migrants in the adult population can increase productivity by 3 per cent long term.

3.61 Scotland must continue to attract people in order to increase our working population and our overall population. Migration is projected to account for all of Scotland's population growth over the period 2016-2041. Maintaining immigration is essential otherwise the number and proportion of people working and paying taxes will fall. The economic activity and employment rates of those born outside of the UK are higher than those in the rest of the Scottish population.

3.62 There are around 429,000 people resident in Scotland who were born outside of the UK, 8.1% of Scotland's total population. Of the UK regions and nations London has the highest share of its population born outside of the UK (38.3%).

3.63 The contribution of non-UK born citizens in Scotland to the Scottish economy is estimated at approximately £12 billion per year.

3.64 The 429,000 Scottish residents who were born overseas are associated with £4.3 billion of government revenue, including income tax and national insurance contributions. Government spending associated with Scottish residents who were born overseas stood at £3.0 billion. This suggests a net contribution to Scotland's public purse of £1.3 billion per year. The Polish born community alone is a net contributor of circa. £250 million.

3.65 We estimate that approximately £1.1 billion in exports in 2015-16 was attributable to overseas students studying in Scotland. Each student from out with the EU generated £26,811 in exports for the Scottish economy in 2015-16 and each student from within the EU generated £14,812. However, given that much of the spending of students is consumer spending in Scotland, like tourism exports these figures are not reflected in reported export statistics.

3.66 Overseas students in Scotland also make a net positive contribution to the UK Exchequer of around £2,500 per person per annum.

3.67 Policy should prioritise Scotland's rankings in the main world competitiveness league tables and related trade-offs considered and agreed for long term policy.

3.68 The attraction of economic migrants (from identified target groups) should be one of the top priorities of Scottish Government economic policy. Policies are recommended to remove barriers provided in UK policy and to incentivise talent to come to Scotland.

3.69 Tone and message matter every bit as much as policy specifics in driving sentiment and human behaviour in this area, the whole country must market itself as a welcoming home for new talent and overseas citizens already based here. We should seek to be the most talent friendly country in the world.

Participation & Inclusive Growth

3.70 There is an economic as well as moral imperative to improve participation and equality. A long-term cross partisan strategy is required.

3.71 International Monetary Fund and World Economic Forum studies identify a direct relationship between improved inequality and growth.

3.72 In income and gender pay inequality Scotland underperforms many of the benchmark small advanced economies to its economic, social and fiscal disadvantage.

3.73 The direct cost of inequality on the Scotland's net fiscal position is estimated at more than £6.4 billion per year.

3.74 The Joseph Rowntree Foundation targets a position where less than 10% of the population are in poverty at any one time. This would be a reduction of 50%, if achieved this could mean a saving of £1.6 billion to the Scottish public finances.

3.75 OECD data show that many small advanced economies have gender pay gaps that are less than half that of Scotland. Median full-time female workers in New Zealand are paid 94.4% what the median full-time male worker is paid, compared to 83.4% in Scotland.

3.76 If gender inequality in Scotland was reduced to the level of New Zealand, Scottish GDP would grow by £6.1 billion and the net impact on public finances would be a possible positive net exchequer impact of up to £2.5 billion.

3.77 Regional inequality within Scotland is less stark than within the UK but requires addressing.

3.78 More localised inequality also needs to be addressed, targeted at the groups in society who have faced significant barriers to full participation in the economy, even in times of economic growth. This will require concerted long-term action to ensure that no one is excluded from opportunities that the majority of us take for granted.

Productivity & Competitiveness

3.79 Increasing productivity growth in the Scottish economy will be crucial and will generate significant economic and social returns.

3.80 There is a widespread view that current economic development arrangements are not adaptable enough to respond quickly to new opportunities for the Scottish economy. Brexit is forecast to worsen productivity.

3.81 All of the approaches to increasing productivity growth require an increase in levels of investment in the Scottish economy, on improved technology, increasing capital intensity, better working practices and policies that encourage the growth of high productivity sectors.

3.82 International competitiveness rankings matter and should be elevated in policymaking, target setting and debate. Agreement should be sought on how Scotland can best achieve the required improvements in relative production costs and prices. One way is through

trade and international ownership because that makes domestic output subject to competition on the world markets (instead of just the domestic markets).

3.83 An increase in trade share of GDP equivalent to 1% of GDP can increase productivity in the economy by 0.4%. More specifically, the benefits to labour productivity and how that feeds through to wages are estimated to be 2-3 times as much.

3.84 Access to international markets is essential. The ability to integrate with international supply chains is critical for competitiveness and to attract foreign investment. The discipline of international competition can also help to drive innovation and new ways of working

3.85 While there are many successful Scottish exporters, Scottish exports are more dependent on a small number of sectors that employ relatively few people.

3.86 Scotland and the rest of the UK have a mutual interest in maintaining a close trade and investment relationship that benefits both. But if the Scottish economy is to realise its full potential, then we must build stronger direct trade and investment links with other European countries and the rest of the world.

3.87 The potential Brexit damage to trade relations with Europe – and the risks to trade relations with other countries – means that Scottish dependence on the UK market is likely to grow after Brexit if Scotland remains part of the UK. This narrowing of Scotland's potential markets will be to Scotland's material economic disadvantage. That this is seen by some as a case for maintaining the current model strikes us as demonstrating a remarkable lack of concern and ambition.

3.88 Maximising frictionless trade and market access with the rest of the UK and with Europe is of critical importance to the performance of the Scottish economy in the short and long term.

3.89 Increasing overseas exports from 20% of GDP to 40% of GDP would be a reasonable target to set in order to close the export gap with small advanced economy benchmark countries, implying an increase from under £30 billion to more than £60 billion. This could deliver a productivity boost of 8% of GDP and would be expected to generate additional taxation revenues of some £5 billion each year.

3.90 In Scotland, as in most other small advanced economies, improvements in productivity will come in myriad small advances, but a few major reforms would make that process a great deal easier – for example finding ways to encourage capital (total factor) productivity and repair the long-standing investment rate deficit.

3.91 Establishing a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful, in particular ways in which policies can be used to bring these opportunities to reality in practice. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model if appropriate.

3.92 The Anholt-GfK Roper Nation Brands Index examines the image of 50 nations. Scotland's score (61.8) and rank (17th) on the index show that Scotland already has a strong national brand. Across all dimensions, with the exception of exports, Scotland is ranked within the Top 20 countries indicating that there is room for improvement in the exports dimension.

3.93 Digitalisation will continue to have an immense impact on the world economy in the coming decades, offering potential in every sector. The digital sector has grown markedly over the past five years and must be continue to be a priority growth sector for Scotland, given its potential long-term significance to the wider economy and also to the ability it provides to widen participation and globalisation in a country of Scotland's geographic position and structure.

3.94 Higher Education Research & Development (R&D) significantly outpaces the UK and EU averages and lags only Denmark, Switzerland and Sweden. Scotland's university sector is a key comparative advantage for any growth strategy. Internationally Scotland's scientific outputs Scotland ranks top, and second to the Netherlands in terms of their influence. However, business R&D investment lags significantly behind EU, OECD and UK averages for both the government investment and business sectors. Improving this measure in key to overall productivity growth, higher investment, and strengthening the competitiveness in the Scottish economy.

3.95 Even within countries and industries there can be large gaps between the most productive and others. The diffusion of knowledge is as important as pushing the boundaries of knowledge. Changes in technology resulting from science and innovation accounted for one-third of productivity growth that took place in the UK between 2000 and 2008.

3.96 There is a positive and leading role for the state in the promotion of R&D and innovation. Building on the Scottish Government's Can Do Innovation Forum, additional initiatives are required to improve commercialisation performance and enhance the role of workplace skills in innovation and the creation of a learning economy.

3.97 Infrastructure is critically important and can deliver significant economic returns on investment. The World Economic Forum's Global Competitiveness Index ranked the UK only 28th in the world on quality of infrastructure. An Infrastructure Commission is urgently required along with a longer-term commitment to increased investment.

The Sustainable Growth Commission

Summary of Main Recommendations – Part A

3.98 Throughout the report a number of recommendations are made. We encourage all of these to be considered immediately in terms both of what can be achieved now. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached, and co-operation sought for policies that would benefit Scotland's performance long-term. However, given the difficulty in persuading a flexibility and pragmatism of approach this may prove impossible. It is clear to us that in order to realise Scotland's potential the normal powers of independence are required.

1. **National Economic Strategy:** The creation of an overarching national economic strategy that (as far as is possible) focuses on long term goals and secures broad cross partisan and sectoral support should be the central goal of growth policy. This is and of itself a necessary but not sufficient factor for success. **Growth goals:** The Strategy should include globally ambitious growth goals, to i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.

2. **Next Generation Economic Model**: A national debate should be commenced on the model we seek for the long-term. Choosing matters and the manner of choosing helps determine the sustainability of the choice, since the central lesson from the success of small advanced economies is that they have achieved consensus about long-term priorities and have a collaborative approach to pursuing those priorities. Our recommended starting point for that national debate, is based on learning the lessons from benchmark small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. The features of that model (leaning especially on the lessons of Denmark, Finland and New Zealand) include: quality of governance, long-term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location, placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective.

3. **Delivering Cross-Partisanship and Collaboration:** A cross-partisan collaborative approach to policymaking against the long-term national strategic framework should be institutionalised. Direct engagement across sectors, business representative, employee representative and other policy groups should be institutionalised to ensure that the national economic strategy remains a vital and dynamic part of policymaking.

4. **Identifying comparative advantage and strategic priority sectors**: while we are leery of the idea of 'picking winners' a clear choice should be considered in identifying and promoting those areas (rather than particular firms) in which we judge the Scottish economy to have sustainable comparative advantage. The process of selecting strategic priorities should be a key output of the process identified in (2) and (3).

5. **Productivity Commission**. We recommend the establishing of a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model if appropriate.

6. **Frictionless borders and market access:** Securing frictionless borders with the rest of the UK and EU should be a top strategic priority of the Scottish Government. Brexit places a material risk on Scotland's access to export and import markets and the free movement of people, capital, goods and services and must therefore be resisted vigorously. The alternative will be a severe reduction in living standards, growth and employment levels. Scotland has more at stake than most small nations in the coherence of the process of fair global integration. The lessons of the Scottish enlightenment and history since must be kept front of mind by all.

7. **Population growth**: Targeting a growing population of working age and the attraction of talented migrants should be a top priority of Scottish Government economic policy and marketed vigorously to the rest of the UK and the world. Scotland should seek to be regarded as the most talent friendly country in the world.

8. **A new 'Come to Scotland' package** should be created with a package of incentives including:

- A 'transition relief' package of tax incentives to reduce the cost of moving to Scotland, and for graduates of Scottish Universities to stay on should be the headline instrument.
- A reduced capital threshold for investors who are required to provide this
- A reduced investment threshold for business start-ups
- A new visa system benchmarked on the most efficient and easy to use in the world

9. **Marketing of 'Come to Scotland':** The marketing of this package and the overall approach should be a major part of the country's international and UK marketing investment and the communications strategy for the internationally facing Scottish agencies. As far as possible the intention will be to secure cross partisan support for the whole approach which also attracts engagement from our major employers, exporters and universities. The budget should reflect the priority as should the engagement of senior Ministers and officials.

10. **Celebration of the contribution of migrants**: A complimentary programme of internally focused public engagement on the contribution of our migrant and 'new Scots' communities should be embedded in the work of the Government, Local Authorities and across Parliament.

11. **International Students and Graduates**: The attraction and retention of international students should be a priority of policy and changes made immediately to alleviate the constraints caused by UK policy. These changes should include both visa changes to allow more students to stay in Scotland long enough to secure employment appropriate to their qualifications and tax incentives for the first three years of employment (in recognition of the social, economic and exchequer contributions already made).

12. **International Government and Multi-national Organisation Strategy**: One of the existing internationally facing elements of the Government or indeed a combined international department or agency should be tasked with creating a strategy for engagement and transitioning of the staff of international governments and multi-national organisations to Scotland. As well as providing a great home for countries and organisations that wish to engage with Scotland the strategy should aim to provide a home for as many international facing organisations in function or headquarter as is possible. A warm

welcome should be matched with a professional service to ease transition cost-effectively.

13. **A Commission on Gender Pay Equality** should be created with a remit to consult and engage across the economy and consider the best policies and incentives to produce a purposeful reduction in the gap with the performance of the best performing small advanced economies, especially New Zealand.

14. **The JRF target of a 50% reduction of poverty to 10%** of the population should be agreed within a stretching but achievable time frame. This policy should be elevated to central strategic importance in the overall strategy and prioritised accordingly in resource allocation.

15. **Long term strategy on participation and inclusion**: agreement should be sought on the central importance of participation and inclusion to sustainable economic growth and a framework set up to oversee long term policy intervention and resource allocation from e.g. The Fund for Future Generations. Whilst inclusive growth is already a policy priority of the Scottish Government, the full powers of independence will provide an opportunity to expand the priority across all policy areas that can contribute, including fiscal policy, industrial strategy, social security, economic participation and fair work, education and skills and community engagement. **Strategic communication on the costs of inequality** should be a priority of government and political strategies. It is important to build a wider public understanding of the realities of the short and long-term costs so that agreement and support can be obtained for longer term interventions.

16. **Labour markets and flexicurity**: Scotland can learn from Denmark and move to a flexicurity model, with flexible labour markets but without the insecurity the UK benefits system promotes. This would be expected to deliver lower unemployment, particularly lower youth unemployment and enhance productivity by stabilising investment incentives. We recommend a consultation of how a move can be made to establish a Scottish flexicurity model.

17. **Competitiveness rankings:** Improving the rankings of Scotland in the main competitiveness rankings should be a core long-term aim of economic policy and the trade-offs involved considered and solutions agreed for the long term.

18. **Competitive Business Taxation:** As part of the review of taxation recommended in Part B we recommend that the impact of business taxation on growth performance is carefully assessed. We are interested in the potential to tailor the Dutch R&D tax credit scheme, enhance incentives for longer term equity investment and improve capital allowances. While we do not consider that competitive use of profit taxation (corporation tax) is an optimal strategic tool, we do recommend that the headline rate of corporation tax should not rise above the level prevailing in the rest of the UK. As with all taxation the impact of the overall structure on both the tax base and revenue generation should be carefully assessed to ensure the more effective system is deployed.

19. **Engagement of International Companies and Sectors**: organisational capacity should urgently be designed and recruited to create and support sector facing business Ambassadors, building on and increasing the prominence of the Global Scots network. This is intended to create a world class dialogue and engagement with those major companies located in Scotland or considering investing in a presence in Scotland to ensure opportunities are maximized and risks mitigated.

20. **Improved data and analysis**: There are gaps in the data that are available on Scotland's trade balance, and on the wider balance of payments position which should be addressed in the short so that the evidence is available on which decisions on policy and assessments of its success can be based. This is an immediate priority.

21. **Infrastructure Commission**: An Infrastructure Commission should be established to provide strategic advice, based on a research programme, to align investment with long term economic development aspirations. This should engage across sectors to seek a national agreement on the long-term priorities and plan. A significant increase in annual investment should be costed and the best means of delivering it identified. If 0.8% of GDP is identified as a go-ahead optimal steady state by some, there is a strong case for a significant increase in this in the short to medium term to ensure catch up in digital and physical infrastructure which will further carry economic benefits that could secure the 'pay-back' to investment in due course.

22. An **Export Growth Strategy** should be created urgently in consultation with the main exporting sectors, companies and potential exporters especially in smaller companies. The aim of this strategy must be to dramatically increase the value of exports overall

and to diversify the source of export income very considerably as countries such as Ireland have achieved in recent decades. The promotion of Scotland's exports should be a central part of the marketing effort of the country alongside migration encouragement. Measures could include the following elements:

- establish a Ministry for Trade and Foreign Affairs to oversee a new and heavily integrated approach to trade, investment and economic diplomacy;
- build a new embassy and consular network with economic diplomacy as its core purpose and with the ability to help harness and direct all of Scotland's international activity;
- retain the link between internationalisation and wider business support through the enterprise networks but with increasing emphasis on, and incentivisation of, growing the number of domestic firms engaged in exporting activity;
- establish a stronger, better funded inward investment agency with an independent and high-level Board including representatives of indigenous and investor business communities;
- direct more resources to trade and internationalisation activities recognising that comparator countries spend more on supporting exports, attracting inward investment and promoting tourism than Scotland currently does; and
- provide financial support mechanisms for exporting businesses e.g. export credit guarantees that are at least as generous as those provided in comparator nations.

23. **National brand strategy**: The development of a national brand and campaign is critical to support broader export. Increasing Scotland's position in the Anholt-GfK Roper Nation Brands Index is a useful benchmark. Resourcing of national brand strategy: The investment in marketing and communications behind Scotland's reputation internationally must be review urgently and benchmarked against the scale and effectiveness of Ireland, New Zealand and Norway, which would imply a ten-fold increase in resourcing. A longer-term view of risk and reward should be central to the judgement on the investment level and major exporters engaged to enhance the overall offer.

24. **National Digitalisation 2030 Strategy**: a core focus on growth strategy must be the adoption of the target to become a world leader in digitalisation by 2030, building on

the Scottish Government's Digital Strategy. A report by Deloitte for the Scottish Futures Trust suggests this could deliver £13 billion to GDP, 175,000 jobs, £2.5 billion in exports and £4.5 billion in tax revenues. The Scottish Futures Trust should be asked to create this strategy immediately identifying the measures required, the role of government and the collaboration needed by the private and other sectors.

25. **Universities Growth Strategy Review**: We recommend a central role for Universities in Scotland's growth strategy and an immediate review of the policies that are required to help them maximise their contribution. This should be led by a combination of academic, investment, business and policymakers.

26. **Government Led Innovation Review**: There should be a policy review to assess the impact of previous interventions and to identify the policy requirements to close the R&D gap, improve the commercialisation performance and identify the role of workplace skills in innovation and the creation of a learning economy. Tax measures such as a Dutch-style R&D tax credit scheme and need for an innovation agency such as Finland's Tekes should both be subject of feasibility studies.

27. **Top 5 Strategic Development Projects**: at any one point in time we recommend that the Scottish Government, Local Authorities and Economic Development agencies should combine to select the top 5 strategic sites for urgent economic development and devote leadership effort and resource to fast-track them. These are likely to be in or around the main cities where the anticipated return on investment is greatest and likely to unlock greater economic activity. The focus of these projects is likely to combine infrastructure, transport and commercial property and residential development in some combination. The Infrastructure Commission could lead the process of selection and oversee delivery. Hub airport development and the opportunity for a freight hub could be specific opportunities to investigate further.

28. **Scottish National Investment Bank**: We support the creation of the SNIB and recommend that the bank participates with other investors on long-term risk bearing projects requiring equity investment and return. We further recommend that this policy move is considered alongside a more comprehensive review of policy in this area and the organisations and structures that deliver it from local government to national agencies. Close co-ordination with the British Business Bank and its investment priorities

would make sense short, medium and long term as would an equivalent dialogue with the Irish Government.

29. **Housing and Growth**: A target should be set for all tenures of housing construction to align to broader migration and population strategy and the development of the planning process. In particular all options should be considered to ensure the investment is made in high quality housing that is far more affordable at all levels than at present. Housing should be seen as an integral part of economic and competitiveness strategy.

30. **Stop Strategy**: It is a relatively simple task to identify more tasks, resources and initiatives that any organisation must engage to improve its performance. It is far more difficult to ensure it stops doing peripheral activity or less impactful work. As part of the economic strategy it is critical that this is a work stream that is prioritised and resourced under senior leadership and governance.

The Sustainable Growth Commission

Part B: The Framework & Strategy for the Sustainable Public Finances of an Independent Scotland

3.99 Part B of the report considers the public finances and the governance and strategy required to ensure they are managed sustainably and with credibility, predictability and transparency. It makes recommendations on the strategy to manage them sustainably and put a credible and respected governance framework in place purposefully.

3.100 This is critically important for any country and especially important for a newly independent country as it transitions to its new governance framework. Those who are required to contribute, or manage, taxation revenues deserve as much foresight and insight on what they will be asked to pay and how. And, of course, the providers of debt finance to sovereigns require comfort that contractual commitments made to them will be honoured and underpinned by credible long-term governance and policy.

3.101 For the purposes of our analysis we have chosen a particular year, commencing 2021-22, as this is the end of the current planning horizon. This should, in no way, be taken as a target date for an independent Scotland. The decision on when to hold an independence referendum is clearly not one for the Commission. However, choosing a specific year aids the analysis as it allows illustrative numbers to be used. . The choice of starting point is not relevant for the overall approach.

3.102 The analysis then examines governance examples and experience from our benchmark group of small advanced economies around the world and makes a series of recommendations for the consideration of the First Minister.

3.103 Clearly the policies undertaken by any independent Scottish Government will depend on the choices made by the electorate in choosing their government. What the Commission's work seeks to do is provide a framework against which future choices may be made, especially through the first five to ten years.

3.104 Whatever it inherits financially on day one of independence it is critical that the Scottish Government moves purposefully to establish credibility and stability in the public finances as it will, for the first time, be going directly to debt markets to seek funding.

3.105 As things stand this will require a clear strategy to get any inherited deficit to manageable levels, in an orderly fashion, over a period of time that is sensible. It will also require a clear policy for the on-going containment of debt. Getting this right is one of the core pillars of creating the success of the newly independent country and its economy and the living standards its citizens enjoy.

3.106 In managing this transition, it is also important that the Scottish Government is careful about the role of public finance policy in stewarding and contributing to the broader economic performance of the country. We can observe from the policy performance of the UK government in recent years that there is a risk that a counter-productive impact on growth can result from mistimed or poorly considered budget choices. It is a truth that bears repeating that managing the public finances is not a zero-sum game of taxation and spending. The critical underpinning is the health of the economy and tax base. The health of the economy over the longer term should be uppermost in the minds of policymakers when making decisions about the budget in the short term and in determining the best course for fiscal sustainability.

3.107 That is not to say that there is any easy route to fixing the public finances from the current model from which they are inherited, there is not. But there is material value – as the evidence from the small advanced economies demonstrates – from tailoring policies to the Scottish economic interest while purposefully securing the credibility we require in creating a sustainable base for the public finances.

3.108 The recommendations set out in this part of the report do not rely on increasing the growth rate. However, there is no doubt that increasing the long term rate of growth would make the task of fixing the public finances considerably easier. Realising the ambitions set out in part A of this report would mean that the targets set in part B would be achieved earlier and a wider range of options would be available for longer term fiscal management.

The Politics of Scotland's Public Finances

3.109 The politics of this debate have dominated Scottish political discourse for many decades. The motivation for this is clear but not particularly relevant for the purposes of this report. In fact, the existence of the Government Expenditure and Revenue in Scotland (GERS) report provides a helpful starting point for our analysis, giving a greater degree of information and transparency that might otherwise be missing. GERS of course allocates revenues and spending according to the accounting conventions of the central government, not necessarily where they actually arise as would happen under the UN or Eurostat convention on national accounts. Thus, given these assumptions and the lack of discrete data on Scotland, the GERS analysis can only be an estimate of Scotland's position that reflects the current constitutional situation. What we can observe from the performance of the Office for Budget Responsibility and the UK Treasury is that forecasting public finances, and the economy, is difficult. This is true of all countries of course.

3.110 Therefore, for our purposes in this report we use the latest Government Expenditure and Revenue Scotland 2016-17[5] as our starting point and project this forward leaning where we can on independent analyses such as the Institute for Fiscal Studies, John McLaren's Scottish Trends[6] and the Fraser of Allander Institute.

3.111 This should ensure that the initial assessment of the 'starting point' is non-controversial. We then make proposals for policy that would not be dependent on any one growth outcome although, obviously, the better the growth performance the better the public finances.

3.112 What is undoubtedly true is that the current position of the country's public finances is an imperative for change rather than staying the same. And it is a reflection of the policies and structures that have created the scale of the estimated deficit as it stands, rather than on those that would seek to put it right. And, of course, this analysis can make no assumption about the ability of the Scottish Government to tailor policies to secure faster growth and therefore, reduce the deficit.

3.113 In political terms, we present a choice for making Scotland's public finances sustainable, purposefully and by our own efforts. It is for others to then judge whether this is preferable to having them ordered in the same manner that got us to the current under-performing position in the first place.

3.114 In addition, the prospect of an extreme Brexit, with Scotland out of the EU and Single Market as part of the UK, is almost certain to make the situation worse, with tax revenues depressed and the very real possibility of a falling working population.

3.115 Given the nature of Scotland's economy, society and geography there is no doubt that the challenges facing the country are distinct from many parts of the rest of the UK. Economies that are resource rich with a large landmass and a relatively small population should be able to steward their resources in a way that secures sustainable revenue sources.

3.116 The opportunity in all of this, for a Scotland with the fuller powers of an independent country, is that it can purposefully address its challenges while taking far greater benefit from its opportunities. Culturally, having rounded responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all.

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[5] The Scottish Government (August 2017), Government Expenditure and Revenue Scotland 2016-17

[6] John McLaren (March 2017), Scottish Trends: Analysis of key economic and fiscal issues impacting on a 2nd Scottish independence referendum

3.117 Finally, a word on North Sea Revenues: Like the deficit discussion the debate on North Sea Revenues has been framed negatively over the last forty years and more to the detriment of its effective stewardship. It has long been SNP policy to establish a Fund for Future Generations. Successive UK Governments have failed to do this. Looking forward it is our judgement that windfalls such as those that occur from the depletion of scarce natural resources should be treated as windfalls and not depended upon for recurring annual commitments. We have proceeded on this basis. Recent investments in the North Sea and the recovery in oil prices suggest an independent Scotland should be able to reap the long-term benefits of oil revenues for many years to come if they are stewarded sensibly.

3.118 Taken together this report should give everyone considering the future of Scotland and its public finances a sense of confidence that the country has both the imperative and wherewithal to manage itself with far greater ambition and sustainability than it has been over the last few decades. How we collectively choose to equip ourselves to achieve this is a separate debate. That this is doable and must be done, should be beyond doubt.

Key Points by Chapter: Part B

Scotland's Public Finances

3.119 Accepting responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all. While this report considers the public finances of an independent Scotland, it is not inconceivable that many of the positive recommendations detailed here could be implemented in advance of such a move.

Annual Solidarity Payment

3.120 An agreement should be sought for a mechanism for Scotland to pay a reasonable share of the servicing of the net balance of UK debt and assets.

3.121 This same mechanism could also include payment for continuing shared services and co-operation for example in the area of international aid for a limited or extended period.

3.122 We strongly recommend that the tone and approach of Scotland to the rest of the UK in those discussions should be informed by the recent and on-going difficulties created by the UK Government's approach to Brexit negotiations.

3.123 Our goal in advance of any independence choice and beyond should be to maintain a relationship that is respectful and as close and positive as between any countries anywhere.

Public finances: assets and liabilities

3.124 The sustainable management of national debt is mission critical to the UK, as it is to any country. Scotland is no different. Any sustainable government policy should be informed by an appreciation of the assets and liabilities passed to future generations.

3.125 Data is available from the UK government on assets and liabilities held by the public sector across the UK. Scotland's per capita share of the UK's non-current assets was £115 billion in 2015-16. After taking account of assets already located in Scotland and (non-pension) liabilities, there would be a net positive balance of £26 billion.

3.126 The fair and equitable division of these assets and liabilities will be the subject of agreement in the event of a positive independence choice. The UK Treasury confirmed in 2014 that existing UK debt instruments remain the responsibility of the continuing UK government. The UK's debt will therefore remain the responsibility of the UK Government after Scotland becomes independent. By definition, an independent Scotland will start with zero debt. The strength of that position should not be underestimated. However, an independent Scotland could choose to agree to contribute to the servicing costs of a fair and reasonable share of UK debt (net of a share of assets).

3.127 A negotiated balance to be serviced by the Scottish Government should take account of the balance of assets and liabilities as the UK currently argues in its negotiations with the European Union. We recommend a balance is paid annually to service UK debt instruments and set out our assumptions based on the data we have available. However, we would expect the true value of assets and liabilities to be examined and debated with greater rigour in advance of agreement being reached.

3.128 For the purposes of our report we take a conservative estimate based on OBR projections and the balances noted and assume an annual debt servicing charge of £3 billion (1.6% of GDP in 2021-22). However, this will fall as a percentage of GDP over time, as a result of inflation and economic growth.

Understanding Scotland's inherited fiscal position

3.129 The existing Government Expenditure and Revenue reports for Scotland estimates Scotland's position within the UK. That is our starting point for analysis. The latest report for 2016-17 identifies a Scottish deficit of 8.3% of GDP.

3.130 Taxes raised in Scotland are sufficient at present to fund all devolved services plus welfare and pensions.

3.131 Scotland contributes substantially to UK tax revenues. It is striking to note that, if London and the South East is excluded, Scotland (excluding oil and gas revenues) contributed 12.6% of the revenues, with 11.3% of the population share, in the latest regional tax statistics.

3.132 We assume North Sea revenues at zero for the purposes of our analysis. That does not mean we are anticipating no revenues. In fact recent investment and revenue projections have been positive. Rather, we recommend that windfalls such as from oil are not allocated to current expenditure but are set aside in a Fund for Future Generations, potentially managed through the Scottish National Investment Bank, for investment in inter-generational projects.

3.133 Approximately 40% of government expenditure allocated to Scotland is by the UK Government.

3.134 From 8.3% in the latest estimates it is anticipated on the basis of OBR and other independent forecasts that the GERS estimate of Scotland's deficit would be 7.1% of GDP by 2021-22. This would have to come down. However, it should be noted the UK has had a deficit at or above this level in six of the last ten years.

3.135 In making comparisons between the possible position of an independent Scotland and the position if Scotland was to remain within the UK, policy choices by the UK Government, not least to leave the EU, which will impact on tax revenue and spending, must be considered.

3.136 The current planning period suggests a 6% cut in the Scottish budget by 2020-21 by the UK Government in addition to the 5% real terms cut experienced since 2010.

3.137 The UK Government's intention to leave the EU and European Single Market is expected to lead to slower growth, with substantial downward pressures on spending.

3.138 Scottish Government analysis shows that Brexit could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030 compared to remaining in the EU.

3.139 The Annual Solidarity Payment is modelled at around £5 billion including debt servicing contributions, 0.7% GNP contribution for foreign aid and a further £1bn set aside for other shared services.

3.140 Scotland's replication of UK budget spend, currently allocated to Scotland in a number of areas, is assumed to be unchanged for our analysis including welfare, pensions, economic development and scientific and university research funding.

3.141 The defence budget is assumed at an initial 1.6% GDP, significantly ahead of the small European country average (1.1%) and the 8th highest in NATO. But it represents a saving on UK plans currently allocated to Scotland and presents spending multiplier opportunities for expanding the Scottish economy.

3.142 Two expert reviews recommended: Comprehensive Review of Inherited UK Spending programmes; Standing Council on Scottish Public Sector Financial Performance.

3.143 We have chosen a specific year, 2021-22, to illustrate the potential starting point of an independent Scotland and a subsequent deficit reduction plan. This should in no way be interpreted as a target date. Rather, choosing a particular year as an illustration allows for realistic forecasts to be made and a better understanding of the choices available.

3.144 As a result of the above analysis we anticipate that in 2021-22 the actual inherited deficit would be, on very conservative assumptions and an acceptance of the GERS analysis, 5.5% of GDP. The difference is explained by the savings from defence (0.4%) and UK central programmes (0.8%) and the impact of net assets/liabilities on the anticipated debt servicing element of the United Kingdom Annual Solidarity Payment (0.4%). This is further adjusted to 5.9% of GDP to exclude North Sea Revenues. This would be the anticipated starting point without any significant policy changes or ambitious growth assumptions.

3.145 This analysis depends on existing UK and Scottish Government published data that will vary over time. However, the direction of travel and broad position detailed should as closely approximate to anticipated reality as any government budget planning can be.

Set-up costs & invest to save opportunities

3.146 Total set-up costs to establish departments and agencies of around £450 million over 5 years, or £90 million per year for 5 years, based on the analysis of Professor Patrick Dunleavy of the London School of Economics.

3.147 Most of these costs would be associated with establishing four new bodies: a defence force and associated defence ministry, a foreign affairs and trade department, a security and intelligence agency, and a central bank and financial regulator.

3.148 Additional civil service personnel of around 4,100, an overall increase of public sector employees of 1%. The costs of additional personnel based in Scotland will have no additional costs (other than those included in transition costs) since these staff are paid for by Scottish taxpayers already, but based elsewhere in the UK.

3.149 Transition costs recovered within 6 years, from additional taxation revenues from the transferred personnel and activity.

3.150 Net economic impacts are positive and substantial, since the additional income associated with transferred employees exceeds costs, even in the transition period, with additional income to the Scottish economy of almost £226 million per year and additional tax revenues of over £75 million.

Fund for Future Generations

3.151 All future North Sea Revenues should be set aside in a new Fund for Future Generations, along with any other windfalls such as asset sales or one-off revenue raisers.

3.152 Such a fund could be established within or invested via the Scottish National Investment Bank, currently being established by the Scottish Government.

3.153 The UK Government has received around £328 billion in real terms revenue from the North Sea production over the past 40 years.

3.154 The role of the Fund would be different in scale and ambition from Sovereign Funds that anticipated the oil boom such as in Norway (the Norwegian fund is worth around £750 billion).

3.155 The focus of this Fund would instead be on risk bearing by the public sector, and on exploiting inter-generational opportunities in the areas of Inclusive Growth, Transformative Innovation and Infrastructure and the Green Economy.

3.156 Further work is required on the detail of its remit and governance.

Fiscal framework and governance: international evidence

3.157 There is a wide variety of evidence of how other small advanced economies have reduced deficits to a healthy and sustainable position. Indeed, many of the fiscal challenges experienced by those economies represent far greater problems than would be inherited by Scotland on our analysis. Scotland's fiscal starting point is challenging, but it is a proposition that is fundable; and making it quickly sustainable is both achievable and essential whether Scotland is independent or not. The real question is how that is best achieved?

3.158 OECD evidence demonstrates average consolidations from fiscal deficits of 7% to 1%, in comparison to Scotland's anticipated starting point of 5.9% to a target of less than 3%.

3.159 In general, small advanced economies pursue policies of more prudently managed debt and deficits than larger countries.

3.160 Small advanced economies tend to respond more quickly and effectively to economic shocks than larger economies.

3.161 Scotland should benchmark itself against the small advanced economies it wishes to emulate in its fiscal policies and governance, rather than against the UK which is not a prudent or successful example.

3.162 Scotland should also learn the lessons of both international examples and recent UK policy history by tending carefully to the impact of any deficit reduction on growth performance. Scotland should explicitly reject the austerity model pursued by the UK in recent years. Scotland needs to focus on both the real economy, and putting finances on a sustainable footing, as dual fiscal goals.

3.163 IMF evidence suggests a gradual pace of fiscal adjustment is only credible if embedded in a medium-term strategy buttressed by strong budget institutions.

Supporting institutions: evidence from small advanced economies

3.164 The structure and design of fiscal policy and governance matters for both sustainable public finances and economic growth. We look to the evidence of successful small advanced economies.

3.165 There are three types of supporting institutions that contribute to successful fiscal management: credible rules, targets and reporting; disciplined budget allocation processes; a structured approach to the government balance sheet.

3.166 International evidence demonstrates that such institutions, with respect for rules and targets, can anchor expectations and build credibility. This is critical for creating sustainable and lowest cost funding of public borrowing.

3.167 International examples are outlined in this report. Long term fiscal targets are recommended with clear guiding principles. A path for fiscal sustainability should be laid out clearly. Clear reporting and transparent accountability arrangements should be put in place.

Budget process

3.168 Robust budgetary decision-making is a necessity for meaningful government control over fiscal aggregates. The international evidence demonstrates that the budget process matters.

3.169 Evidence suggests that the budget process is at least as important as the rules themselves.

3.170 Small advanced economies perform better on OECD measures of high performing budget processes than large economies. There is increasing consensus on best practice across developed countries.

3.171 The Scottish Government should aim to strengthen the decision-making process, increase the quality of resource allocation and consider new tools such as a systematic process of structured spending reviews across major spending areas, bottom-up. The best performing countries (such as Denmark) should provide the benchmark.

Taxation system: principles and strategy

3.172 Borrowing on the work of the Scottish Government's Fiscal Commission Working Group we highlight the issues and opportunities for the taxation system in Scotland and recommend further work.

3.173 The decisions that are taken by government on the design of taxes and tax rates set should take account of the likely economic impact on the economy, including on behaviour of individuals and on businesses. This should include regard for maximising revenues, since increasing (or reducing) rates does not always lead to increased (or reduced) revenues; taxpayers can often change behaviour as a result of the changes made.

3.174 A comprehensive review of the Scottish taxation system beyond income tax is recommended drawing on the best global expertise and experience with a view to recommending reforms to improve simplicity, neutrality and flexibility.

3.175 A cross-partisan approach is sought.

Managing the government's balance sheet

3.176 Substantial value to governance and finances will flow from effective management of the public sector's portfolio of assets and liabilities; and its balance sheet. This does not mean the privatisation programmes such as those that the UK has pursued, but maximising value to the public purse of assets it holds.

3.177 The IMF estimates developed world balance sheets are commonly circa. 70% of GDP. The UK balance sheet is smaller and for many countries the assets outweigh the stock of public debt.

3.178 Better allocation of capital should be a priority at all times. A good understanding of the balance sheet gives the most informative measure of financial sustainability.

3.179 Examples are examined from small advanced economies to better allocate capital and assets and manage debt and risk.

3.180 Scotland should quickly establish a best in class Debt Management and Assets Office, with consideration being given to allocating broad aggregate balance sheet responsibilities to this institution.

3.181 A comprehensive and accurate inventory and valuation of assets and liabilities held by the Scottish Government and public sector should be undertaken and maintained.

3.182 Opportunities for capital release into the Fund for Future Generations should be reviewed every 3 years.

3.183 An on-going and robust system for asset management and reporting should be created.

Creating a credible and sustainable fiscal framework & policy

3.184 Target a deficit value of below 3 per cent within 5 to 10 years.

3.185 National debt should not increase beyond 50% of GDP and should stabilise at that level.

3.186 Borrow only for public investment in net terms over the course of the cycle.

3.187 During the transition period real increases in public spending should be limited to sufficiently less than GDP growth over the business cycle to reduce the deficit to below 3% within 5 to 10 years. At trend growth and target inflation rates this would mean average annual cash spending increases of above inflation in contrast to the Scottish budget experience under the UK regime of recent years and that scheduled for the remainder of the current planning period.

3.188 The impact of fiscal management on growth must be tended to and it should be noted that this rule will apply over the business cycle. This means that in periods where growth is expected to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth.

3.189 Governance recommendations from preceding chapters should be delivered swiftly and purposefully.

3.190 Initial premiums on borrowing costs compared to the UK are not anticipated to be problematic but the target of policy should be to reduce the gap towards small advanced economy benchmarks. An assumption is made that initial debt interest costs could be 100bps above UK levels, the level estimated by the ratings agencies in 2014.

3.191 10 year debt accumulation is not anticipated to rise over 40% of GDP. Scotland's commitment through the Annual Solidarity Payment on UK debt servicing would affect deficit rather than debt.

3.192 The analysis set out in this report shows that the target of a deficit value of below 3 per cent within 5 to 10 years can be achieved without any assumptions in increased growth. Achieving the growth aspirations set out in Part A would have the effect of bringing forward the timescales required to meet the fiscal target.

3.193 A potential transitionary fiscal boost to growth should be considered and should be consulted on, depending on the prevailing economic circumstances and the perspectives and price required by debt providers.

Main Recommendations – Part B

3.194 As with Part A we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached and co-operation sought for policies that would benefit Scotland's performance long-term.

31. **Annual Solidarity Payment:** Following a successful independence vote an Annual Solidarity Payment should be created to allow the Scottish Government to pay an agreed share of the servicing of a net balance of UK debt and assets and any continued shared services payments.

32. **Comprehensive Review of Inherited UK Spending Programmes:** reporting within two years this would analyse the inherited strategy and choices for spending across the UK programmes excluding defence which would be subject to separate consideration. The purpose would be to identify savings from costs that need not be replicated, and tailoring to Scotland's specific position and needs. A saving of £1 billion should be targeted. As government functions are transitioned, further savings should be targeted by replacing the UK approach with institutions modelled on the best of the small advanced economies e.g. in tax collection. This element should target a saving of 0.3% of GDP by year 5.

33. **Standing Council on Scottish Public Sector Financial Performance:** this should be established to institutionalise the high performance and best practice (compared

internationally) across the public sector; incentivising, celebrating and rewarding the best outcomes and efficiencies.

34. **Fund for Future Generations:** this fund should be created from all windfall revenues including any from North Sea oil and gas. The focus of the fund would be on risk bearing by the public sector in exploiting inter-generational opportunities in the areas of Inclusive Growth, the Green Economy and cutting-edge innovation projects. Further work is required on the detail of its remit and governance.

35. **Fiscal Targets:** should be established and adhered to:

    i) Public debt should be maintained at no more than 50 per cent of GDP with borrowing only for public investment in net terms over the course of the cycle.

    ii) Public sector deficit should be reduced to below 3 per cent of GDP and maintained at levels consistent with a 50 per cent debt threshold. Over time the definition of fiscal balance should be extended to a broader balance sheet perspective to ensure no 'off-balance sheet' practice diminishes transparency.

36. **Scottish Fiscal Commission**: the resourcing and remit should be extended as policy competences are increased over time. Consideration should be given to its ability to measure the distributional impact of financial measures as well as the broader macro-economic and fiscal implications.
37. **Budgetary Process Review and Implementation**: the Finance Ministry should lead a budget process to ensure the fiscal transition is delivered effectively. The government's strategic priorities should determine negotiations with spending departments along with high quality spending proposals and a rigorous ongoing review of them. Such a review and implementation should borrow from the best international examples and be implemented as an immediate priority and dovetail with the Standing Council on Scottish Public Sector Financial Performance. The outcome should be a systemic process of structured spending reviews as in countries such as Denmark.
38. **Comprehensive Taxation Review**: is recommended drawing on the best expertise and experience globally with a view to recommending reforms to improve simplicity, neutrality and flexibility. This review should also target a reduction in the inherited UK 'Tax Gap', the difference between actual and anticipated revenues. Given the nature of such a review should be designed to outlast any one Parliamentary term it would be beneficial if a cross-partisan approach could be achieved.

39. **Debt Management Office**: This should be established to a 'best-in-class' standard to manage the debt stock and issuance of debt.
40. **Asset and Liability Management Office**: In due course the DMO should be extended to have broader aggregate balance sheet responsibilities for financial and other asset holdings.
41. **National Balance Sheet Review**: a comprehensive inventory of assets and liabilities held by the public sector should be undertaken and valued transparently. As well as allocating responsibilities to their management including an assessment of whether the public sector remains the best possible owner of them. Such a process would be ongoing but with an initial reporting period of two to three years. A robust system for asset management and reporting should be established.
42. **Deficit Reduction Policy**: this should be established with a target of delivering the initial deficit target of under 3 per cent of GDP within 5 to 10 years. Public spending increases in transition should be limited to sufficiently less than money GDP growth to deliver this. At trend rates of growth and inflation this would allow annual average cash increases of above inflation.
43. **Transitionary Fiscal Stimulus**: a fiscal stimulus to growth should be considered and consulted on depending on the prevailing economic circumstances and the perspectives and price required by debt providers. It should be designed to enhance the ability of the economy and public finances to deliver the medium-term consolidation target.

Part C: The Monetary Policy and Financial Regulation Framework for an Independent Scotland

3.195 Part C of the report considers the question of the currency that Scotland should use and the approach to monetary policy and financial regulation in the event of a successful referendum on independence.

3.196 In weighing up the options the Commission was able to draw on the wealth of work undertaken in advance of the 2014 referendum as well as the experience and debate through that referendum. This part sets out our view on the best way forward.

3.197 In coming to our view, we have listened carefully to all sides of the debate. We have weighed up the reality of autonomy and the effectiveness of monetary policy as a tool of economic growth policy for all countries. We have considered this reality against the transitional implications for the real economy given the nature of the Scottish economy and its close integration, financially, with the rest of the UK.

3.198 Scotland would start any independence transition from a position of greater financial and economic integration with the rest of the UK than any other country in recent decades who has made an independence choice. Similarly, the financial services sector, in all its forms, is of greater importance to the Scottish economy than any other country that has made such a transition in post-war history.

3.199 Our approach is therefore to prioritise as far as possible, the removal of any uncertainty around the detailed process of transition for individuals, companies, investors and the wider economy.

3.200 It is our view that the role of Monetary Policy and Regulation Policy should be to provide continuity and stability throughout the period of transition and beyond. It is possible that in due course a different approach may have merit depending on the performance of the economy. It is only once the public finances have reached their fully sustainable position and the full institutions of government transitioned and set up that any alternative approach should be considered or 'earned'

3.201 Our framework of transition suggests a minimum period of two years from any successful independence vote and the starting point of independent policy. We then anticipate a period of between five and ten years to put the public finances on a sustainable footing.

3.202 Substance matters a great deal more than symbols. There will be much work to be done to bridge the gap between Scotland's performance and potential. The prize will be a far better economic performance and living standards and a society modelled on the long-term

choices of the people who make their lives in Scotland. The idea that there is any quick fix or silver bullets available is neither real nor sensible to contend. But there is a strong opportunity to make clever choices on the priorities for the collective effort of the country through government policy. The three reports of this Commission have set out our view of the purposeful way to approach it all.

Currency Recommendation

3.203 The Commission recommends that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period.

3.204 A future Scottish Government should put in place the arrangements and financial infrastructure that would support a move to an independent Scottish currency at such time as this was considered appropriate for the Scottish economy.

3.205 What happens with respect to currency the day before an independence vote would happen the day after and continue to happen until such time as the elected Scottish Government seeks to do something differently.

3.206 The Commission recommends that a decision to move to an independent Scottish currency should be based on a governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is a necessity to maximise certainty and stability, and to minimise risks. We recognise that this means that the Scottish Government would not secure monetary policy sovereignty in the initial period following an independence vote though the Scottish Government would not be in a formal monetary union.

3.207 This option allows the focus of the government, individuals, investors and businesses to be on policy choices for growth and the sustainability of public finances and the development of necessary institutions. It also removes a range of uncertainties concerning existing arrangements and contracts.

3.208 We note that this was the approach taken by Ireland for an extended period, albeit in a different period of history.

3.209 The existing financial assets and liabilities of Scottish residents, and the financial assets and liabilities which residents of countries outside Scotland hold with Scottish institutions, are assets and liabilities of these individuals, businesses and institutions, not assets or liabilities of the Scottish Government, before or after independence.

Future options: governance & tests

3.210 The arrangements supporting the Scottish currency and the Scottish financial system should allow for the possibility that the Scottish Government may choose to establish a separate currency at some future date.

3.211 In order to secure maximum long-term certainty, we recommend that the governance and rules by which any future choice could be taken be set in advance.

3.212 The introduction of a separate Scottish currency, would be subject to six tests, an assessment of which would be made by the Scottish Government and put to the Scottish Parliament for approval:

1. **Fiscal sustainability**: Has the Scottish Government sustainably secured its fiscal policy objectives and sufficiently strong and credible fiscal position, in relation to budget deficit and overall debt level?
2. **Central Bank credibility and stability of debt issuance**: Has the Scottish Central Bank and Government framework established sufficient international and market credibility evidenced by the price and the stability of the price of its debt issuance?
3. **Financial requirements of Scottish residents and businesses**: Would a separate currency meet the on-going needs of Scottish residents and businesses for stability and continuity of their financial arrangements and command wide support?
4. **Sufficiency of foreign exchange and financial reserves:** Does Scotland have sufficient reserves to allow currency management?
5. **Fit to trade and investment patterns:** Would the new arrangement better reflect Scotland's new and developing trading or investment patterns?
6. **Correlation of economic and trade cycle:** Is the economic cycle in Scotland significantly out of phase with that of the rest of the UK, or at least as well correlated with the cycles of other trading and investment partners, thus making an independent monetary policy feasible and desirable?

3.213 The conditions and rules that would determine a change of monetary policy and currency choice should, as articulated in this chapter, be made very clear in advance. In the event of a new Scottish currency being created it is likely that a period of 1:1 pegging with sterling would make sense for the short and possibly medium term.

Scottish Central Bank and Scottish Financial Authority

3.214 The Commission recommends that two new institutions are set up, the Scottish Central Bank (SCB) and a Scottish Financial Authority (SFA), which would be an independent wholly owned subsidiary of the Scottish Central Bank.

3.215 These new institutions should be created to provide the governance, necessary functions, structures and approaches of the existing UK institutions. The resourcing, scale and less complex nature of Scottish institutions would reflect the simpler structure and the different composition of the Scottish financial system.

3.216 The Scottish Central Bank would assume final responsibility for the functions, in Scotland, of the FCA and the PRA in the UK through its SFA subsidiary (including both banking and insurance supervision).

3.217 It would act as banker to the Scottish Government, and hold deposits and provide liquidity support, subject to the asset and collateral requirements, for Scottish retail banks, to the extent necessary to protect retail depositors. The SCB would operate a clearing system for these banks. It would also establish a Scottish Financial Services Compensation Scheme similar to the UK FSCS.

3.218 As a result, there is no reason why Scottish businesses and individuals should expect to borrow on terms in any way different from their rest of UK counterparts.

3.219 Banks operating in Scotland with Scottish headquarters or through Scottish subsidiaries (and hence regulated by the SCB) would be required to ring-fence their retail banking operations along the same lines as now proposed for the UK. The SCB would put in place a resolution regime similar to that in the UK for the orderly winding down of failed banks. Financial support from the SCB would not extend to the holding companies of retail banks to cover activities outside Scotland, or beyond what is needed to ensure that retail depositors in Scottish banks are protected. It is anticipated that a number of banks may re-domicile their registered headquarters to London. A substantial part of the executive functions of these banks is already in London and so there would be a very limited impact on operational activity.

3.220 The supervisory culture and institutional structures in Scotland will remain closely aligned with the arrangements for the rest of the UK and Scotland should aim to become a natural bridge between the rest of the UK and the EU.

3.221 The SFA will focus on all other parts of the financial sector in Scotland.

3.222 It is anticipated that it would operate a unitary regulatory model combining prudential and conduct regulation.

3.223 The transition arrangement should seek to 'grandfather' as much as possible from the UK arrangements.

Main Recommendations – Part C

3.224 As with Parts A and B we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control.

44. **Currency Recommendation – Sterling Retention:** The Commission recommends that the currency of an independent Scotland should retain the pound sterling for an extended transition period.

45. **Currency future options: governance and tests:** In order to secure maximum long-term certainty, we recommend that the governance and rules should be set in advance. We recommend 6 tests detailed in the report for a future decision on currency to be based upon:

    i) Fiscal sustainability

    ii) Central bank credibility and stability of debt issuance

    iii) Financial requirements of Scottish residents and businesses

    iv) Sufficiency of foreign exchange and financial reserves

    v) Fit to trade and investment patters

    vi) Correlation of economic and trade cycle

46. **Scottish Central Bank: should be established.** This should be created to act as banker to the Scottish Government, holding deposits and providing liquidity support (subject to asset and collateral requirements) for Scottish retail banks and provide a clearing system for these banks. assuming the functions in Scotland of the FCA and PRA through its SFA subsidiary.

47. **Scottish Financial Authority:** as an independent wholly owned subsidiary of the Scottish Central Bank. Adopting the responsibilities of the UK FCA and PRA it would also take the lead on other (non-banking) parts of the financial sector in Scotland.

48. **Scottish Financial Services Compensation Scheme:** should be established by the SCB mirroring the UK FSCS scheme.

49. **Bank regulation:** banks regulated for their activities in Scotland by the SCB/SFA would be required to ring-fence their retail/commercial and mainstream corporate banking operations. A resolution regime would be established mirroring the UK approach for the orderly winding down of failed banks. The transition arrangements would 'grandfather' as much as possible from the UK arrangements.

50. **Lender of Last Resort:** the SCB will act as lender of last resort to individual banks with a liquidity rather than solvency problem and provide emergency liquidity assistance to the banking system where there is a systemic need. After consultation, the SCB would introduce rules on capital structure and asset quality on retail banks to ensure that adequate collateral is available to match retail deposits in such banks. Financial support should only be provided to the ring-fenced retail entities operating in Scotland. It should not extend to the holding companies of retail banks whether operating in Scotland or elsewhere.

The Sustainable Growth Commission

4 CONCLUSIONS AND NEXT STEPS

4.1 This report is now passed to the First Minister for the consideration of her party and Government as it determines the course of its economic policy approach for the short, medium and long term. It is also offered to all sides in the political and economic debate in Scotland (and indeed further afield) in the hope that it represents a considered and elevating contribution to the debate.

4.2 The Commission does not suggest that any part of the report represents the 'last word' on any of the topics we have examined. What we earnestly hope, however, is that it creates a framework and level of content that allows the level of debate to mature considerably. While we are perfectly aware of the likely responses of many critics to the immediate publication in what is often both a fierce and shallow political discourse, we do anticipate that its value will come longer term as all sides consider carefully the best interests of the country in what is a remarkable era of tumult in the global system.

4.3 We also recognise that some of the analysis and conclusions of this report represents a challenge to established thinking. We do not expect universal support from within the party or indeed from anywhere. However, we would not have been doing our job and addressing the remit we were given without being prepared to adopt such an approach.

4.4 Inevitably, much of what we recommend involves further work, analysis and consideration. We encourage a purposeful approach to commencing that as soon as is practicable.

4.5 If the electorate of Scotland is asked to choose again on the question of independence, this report should mean that it will do so with more information, understanding and certainty than that previously offered on any choice of such magnitude. In the meantime, this work should enhance understanding and debate in a way that we hope can raise the quality of policy ambition across the political spectrum.

The **Sustainable Growth** Commission

Part A
Raising the Potential & Performance of the Scottish Economy

May 2018

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The Sustainable Growth Commission

A1 SCOTLAND'S ECONOMIC PERFORMANCE & POTENTIAL

- Scotland is without question a rich and successful nation, in the top 25 of global economies in terms of income per head and ranks near the top in the UK on most long-term indicators.
- Scotland has very significant comparative economic assets and advantages, in terms of natural resources, the education and skills of the people who live in Scotland and sectors with existing and potential global competitiveness.
- It is energy-rich with oil and gas resources, up to 25 per cent of Europe's tidal power potential and 25 per cent of Europe's offshore wind potential.
- We have world-class universities, a world-wide reputation for premium food and drink products and our country has been named the world's most beautiful, boosting our outstanding tourism industry. We are at the cutting edge of games technology, photonics, life sciences, advanced manufacturing and other industries of the future.
- Despite these abundant resources, other independent countries with the ability to tailor economic policy to their own needs have performed better than Scotland. The median income of the group of 12 small advanced economies[1] is 14% higher in GDP per head; a gap of £4,100 per person. This shows what is possible for an independent Scotland.
- The economic debate was at the heart of the 2014 referendum[2]. That debate was predicated on the assumption that the UK would continue to be a member state of the EU.
- A key argument from the pro-independence side was that the UK economy was unusually unbalanced – both in terms of geographical performance and inequality in income and wealth among UK citizens.
- This report shows very significant regional disparity of performance in the UK. The gap in performance by local areas is by a distance the most unequal in Europe, with far too much economic activity and opportunity concentrated in London and the South-East of England.
- The gap between rich and poor in the UK continues to be one of the largest among developed countries, with growing evidence that such inequality acts as a drag on economic performance.

[1] The reference group of 12 small advanced economies consists of Austria, Belgium, Denmark, Finland, Hong Kong, Ireland, the Netherlands, New Zealand, Norway, Singapore, Sweden, and Switzerland

[2] Reports published included the UK Government's Scotland Analysis Papers; Scotland's Future, the White Paper published by the Scottish Government and other papers such as Building Security and Creating Opportunity: Economic Policy Choices in an Independent Scotland, published by the Scottish Government in 2013.

- A dependence on consumer debt fuelled spending for growth has been a consistent feature of the UK economy and is not sustainable and carries very significant risks.
- The UK's export performance has been poor and with a falling share of the global market. The UK has – by far – the highest trade deficit in the EU.
- Scotland performs close to the UK average in terms of economic performance per person but has not enjoyed similar levels of population and labour force growth.
- If Scotland had matched UK population growth since 1980, the population of Scotland would now be 5.8 million, if it had matched the population growth of the other small European countries (such as Austria, Denmark, Finland, Ireland, Norway and Switzerland) there would be 6.1 million living in Scotland.
- If the gap between Scotland's real per capita income and the median of the small advanced economy group was closed, income per head would be 14 per cent higher. Closing the gap between Scotland and the best performers would increase incomes by over a half. Closing this gap would mean, in today's values, an additional £22 billion in additional GDP and a potential additional £9 billion in tax revenues
- The decision of the UK to leave the European Union will fundamentally change Scotland's economic future. Brexit will almost certainly widen, not narrow, the gap between Scotland and comparator countries.
- The UK Treasury says Brexit will make the UK "permanently poorer". This is not a controversial claim. There is a widespread consensus among economists, with few exceptions, that leaving the EU will damage UK economic growth, productivity and job creation.
- The Fraser of Allander Institute estimate a potential Brexit impact of the loss of between 30,000 and 80,000 jobs, the loss of between £3 billion and £8 billion in GDP and a real wages cut of £2,000, depending on the model that succeeds Brexit negotiations.
- Scottish Government modelling shows an adverse impact on trade, productivity, population and foreign direct investment. And LSE's Programme of Brexit research suggests Scotland (as well as Wales and Northern Ireland) are already being disproportionately hit by the impact of the Brexit vote.
- The already huge difference in economic performance between London and the South-East of England and other parts of the UK is therefore likely to increase.
- This means it is essential to stimulate an inclusive, national debate on Scotland's economic future to find out whether a different, better path is possible.
- Scotland's resources and talent, combined with good decision-making and the ability to tailor policy to our needs, can lead to improved economic performance and avoidance of the low growth future in a UK outside the EU. The growth aspirations here are structured over three time horizons: (i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of

3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.

- The long-term nature of the strategy should not diminish its urgency. It must begin now.

Scotland's Assets and Advantages

A1.1 The debate on the strength of the Scottish economy generally focuses on short-term indicators of performance such as the latest GDP or labour market statistics that have been published. While of course these are important pointers, it is also important to consider the Scottish economy's long-term prospects with consideration given to Scotland's comparative economic assets and advantages.

A1.2 Scotland is without question a rich and relatively successful nation, it is in the top 25 of global economies in terms of income per head and ranks near the top in the UK on most long-term indicators, behind only London and the south east of England.

A1.3 Scotland has very significant comparative economic assets and advantages, in terms of natural resources, the education and skills of the people who live in Scotland and sectors with existing and potential global competitiveness.

A1.4 Scotland has been an energy producing country since the industrial revolution, initially coal and since the 1970s, oil and gas. Energy services has become a global business, with international activity now accounting for more than half of total sales in Scotland's oil and gas supply chain companies, with a value of more than £11 billion in 2015[3].

A1.5 As the global economy transitions to meet the challenges of climate change, Scotland will retain competitive advantage in energy. In 2016, Scotland generated 54% of its electricity demand from renewable sources (principally hydro and onshore wind)[4]. Scotland has the majority of the UK's onshore wind energy resources and the seas around Scotland have up to 25% of Europe's tidal power and 10% of its wave power and around 25% of the European offshore wind resource potential[5].

A1.6 Other natural resources that will be valuable in the future include water resources and the natural environment as well as many cities and towns ranked highly for the quality of life that they provide.

[3] Source: Aberdeen Chamber of Commerce (2017) Survey of International Activity in the Oil and Gas Sector 2015-16

[4] Source: Scottish Government (2017), Energy Statistics Summary

[5] Source: http://www.gov.scot/Topics/marine/marineenergy

A1.7 Five Scottish universities appear within the top 200 universities[6]. The quality of impact of Scottish science is evidenced by analysis[7] that found that Scotland was top for peer-reviewed scientific publications per year per researcher and was second only to the Netherlands for research citations per researcher (a measure of the influence of the findings). As well as being internationally competitive in the global higher education and research markets, universities are increasing drivers of economic growth, forging and growing new industry sectors.

A1.8 Scotland has a worldwide reputation for producing premium food and drink products. In 2016 exports of these products amounted to £5.5 billion[8]. Successful export sectors include Scotch Whisky and more recently Scottish Salmon.

A1.9 Scotland is home to one of the largest life sciences clusters in Europe. Scotland has long been a pioneer in medical education and research and more medical research is carried out per capita in Scotland than anywhere in Europe[9].

A1.10 Scotland's natural environment and vibrant urban areas attract tourists. Scotland was included at number 2 in the Rough Guides top ten 'must see' places to visit in 2017[10]. There have been many innovations in the tourism sector, not least the role of festivals and events, and continuing innovation can deliver substantial further development in this rapidly growing global sector.

A1.11 Scotland also has a well-qualified workforce with an estimated 60% of the working age population having tertiary education qualifications, amongst the highest in the OECD group of advanced economies[11].

A1.12 Scotland has been one of the best performing parts of the UK for inward investment, attracting record numbers of projects in 2016 and has become the leading part of the UK for research and development inward investment projects[12].

A1.13 The financial services sector in Scotland has a long history and global reputation, particularly in high value areas such as insurance and asset management.

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[6] Source: The Times Higher Education World University Rankings 2016-17 https://www.timeshighereducation.com/world-university-rankings/2017/world-ranking#!/page/0/length/25/sort_by/rank/sort_order/asc/cols/stats

[7] Source: Elsevier Analytical Services (2016), International Comparative Performance of the Welsh Research Base

[8] Source: Scottish Government (March 2017), Scotland Food and Drink Exports, 2016

[9] Source: Scottish Government, Life Sciences – Key Sector Report

[10] Source: Rough Guides (January 2017)

[11] Source: Based on ONS Labour Market Profile for Scotland and UK (2016) and OECD Education at a Glance 2017

[12] Source: Ernst & Young (2017), Scotland Attractiveness Survey

A1.14 Scotland also has a number of clusters of highly competitive companies operating in niche global markets, some well-established, others more recent or emerging. These include computer game designers, textiles, quantum and nano-technology, chemical manufacturing, specialist manufacturing, robotics and artificial intelligence, digital and data technologies and precision medicine and life sciences. The further development of emerging sectors requires much higher skills than many traditional sectors, providing opportunities to further leverage Scotland's universities and colleges.

A1.15 These assets and advantages are greater than many comparable countries, and Scotland's economic potential is significant.

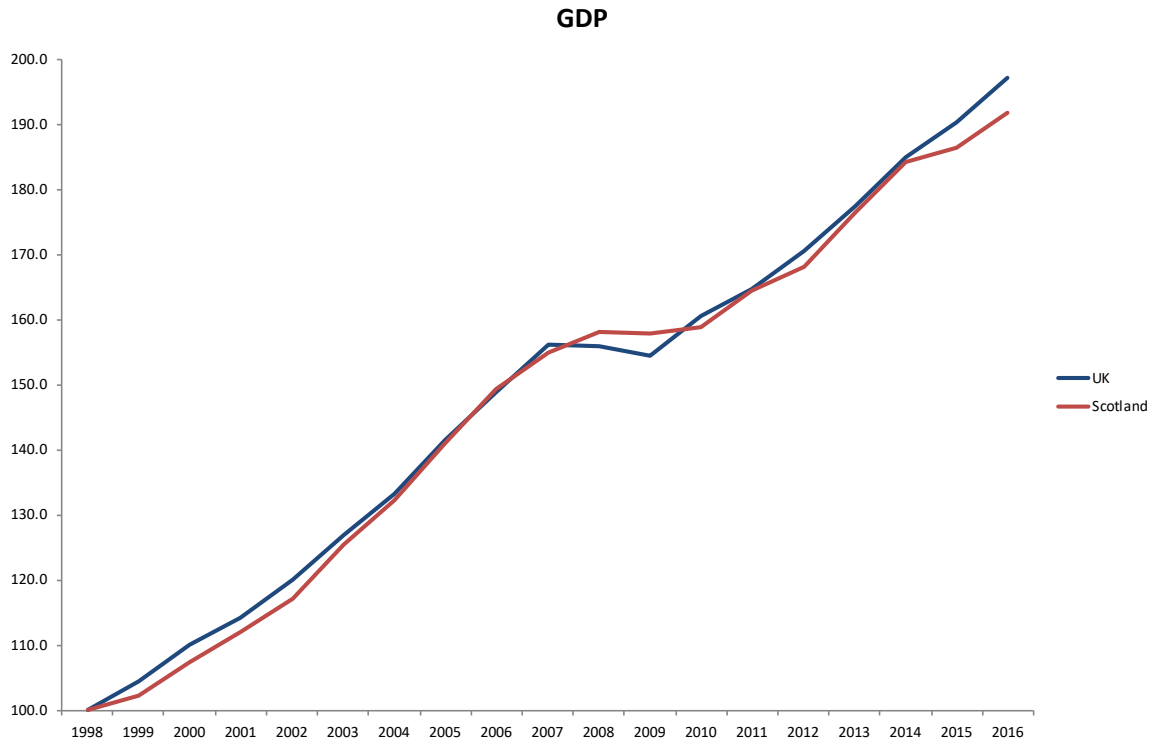
Comparative Performance of the Scottish Economy

A1.16 The GDP of Scotland in 2016/17 was £159.4 billion or £150.0 billion excluding the contribution of oil and gas[13], which is equivalent to a GDP per Capita of £29,500, or £27,800 excluding oil and gas. This compares with £29,800 for the UK overall.

A1.17 The long-term Scottish economic growth rate has lagged the UK rate by around 0.5%. Since devolution, Scottish growth has generally been close to the UK growth rate, but has failed to close the gap, and since the financial crisis and the fall in oil prices, it has widened (Figure 1-1). It should also always be remembered that overall UK economic performance statistics mask very large regional disparities.

[13] Scottish Government (2016), Government Expenditure and Revenue Scotland, GDP including North Sea Geographical Share

Figure 1-1 – Nominal GDP (Scotland and UK, 1998-2016)

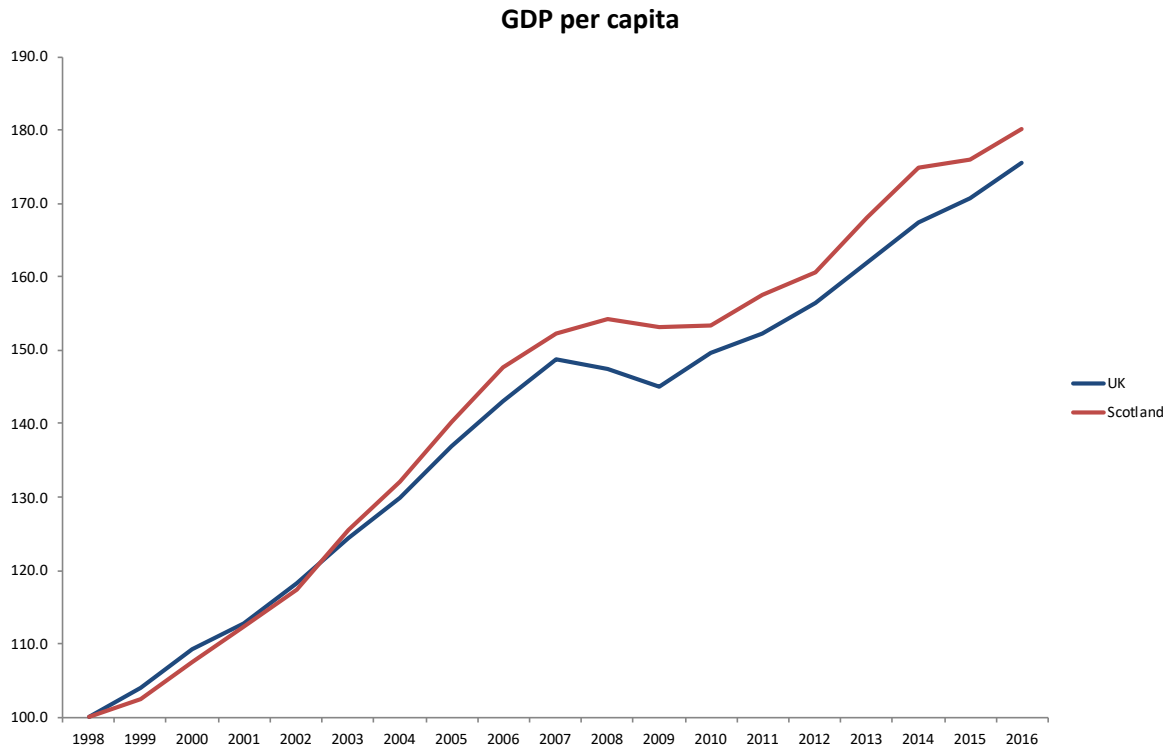


Sources: Government Expenditure & Revenue in Scotland (GDP estimates, Onshore)

A1.18 Measured in GDP per capita terms, the performance of the Scottish economy benchmarks better against the UK (Figure 1-2), although, as we come on to discuss the UK economy has been underperforming and so it provides an unambitious benchmark.

A1.19 The main reason for this difference is the divergence in patterns of migration, with Scotland having much lower population growth than the UK. This has been driven by emigration as Scots sought opportunities elsewhere (particularly in the pre-devolution period) and lower immigration than the rest of the UK. Population trends can be an indicator of economic health, but GDP per capita is a more useful measure of economic performance, not least because it facilitates comparison between economies.

Figure 1-2 – Nominal GDP per Capita (Scotland and UK, 1998-2015)



Sources: Government Expenditure & Revenue in Scotland (GDP estimates, Onshore)

A1.20 So, on one measure of the economy (scale) Scotland's growth consistently underperforms the UK, while on the other (prosperity) it performs better.

A1.21 The key point this report seeks to address, however, is not the past but the future performance of the economy and in particular, whether it is best for future generations for Scotland to be part of a low growth, unbalanced, UK economy outside the EU, or to adopt the Next Generation Economic Model for Scotland outlined later in this report. The key is to focus on the drivers of growth – the three 'Ps" and on the best performing small countries globally.

Components of Economic Growth

A1.22 In an advanced economy, there are three main components that help explain where economic growth comes from, and so three potential high level targets for economic growth policies, the three 'Ps" of growth:

- Population: the numbers of working age people.
- Participation: the proportion of those working age people that are participating through the economy through employment and other wage and profit earning activities.

- Productivity: a measure of the output that is produced with a given set of inputs. There are several measures of productivity, including output per hour worked, a measure of labour productivity. Total factor productivity would be a better measure if data was available.

A1.23 The drivers of growth can be quite different for national GDP and GDP per capita. National GDP growth is often driven by the workforce expanding, either through reduced emigration or increased immigration or by increasing the economic activity rate of those individuals already living within the country - for example, increasing the female participation rate in the paid workforce or reducing the level of long-term unemployment. National GDP growth can also come from increased resource use, such as through a greater exploitation of oil and gas resources. Some of this increase in resource may be unsustainable if it is a finite resource, however the increased national use of well-managed renewable resources would not impede the abilities of future generations to grow.

A1.24 The growth of GDP per Capita is more closely related to productivity increases within the economy. This is the ability for individuals to gain a greater level of output for a given set of outputs by doing things differently or better. The conventional economic theory on how this growth is achieved focuses on five key drivers of productivity, these are:

- investment in physical capital such as public infrastructure, consumer durables or plant and machinery for production;
- increase in skills and human capital;
- innovation of new and improved products and processes;
- entrepreneurship; and
- competition and increased competitiveness.

A1.25 In addition to these factors, developing economic theory has identified additional drivers of productivity growth. These are:

- social capital;
- industrial structure;
- agglomeration effects;
- openness and trade;
- regulation;
- absorptive capacity (of new technologies);
- new knowledge; and
- reducing waste.

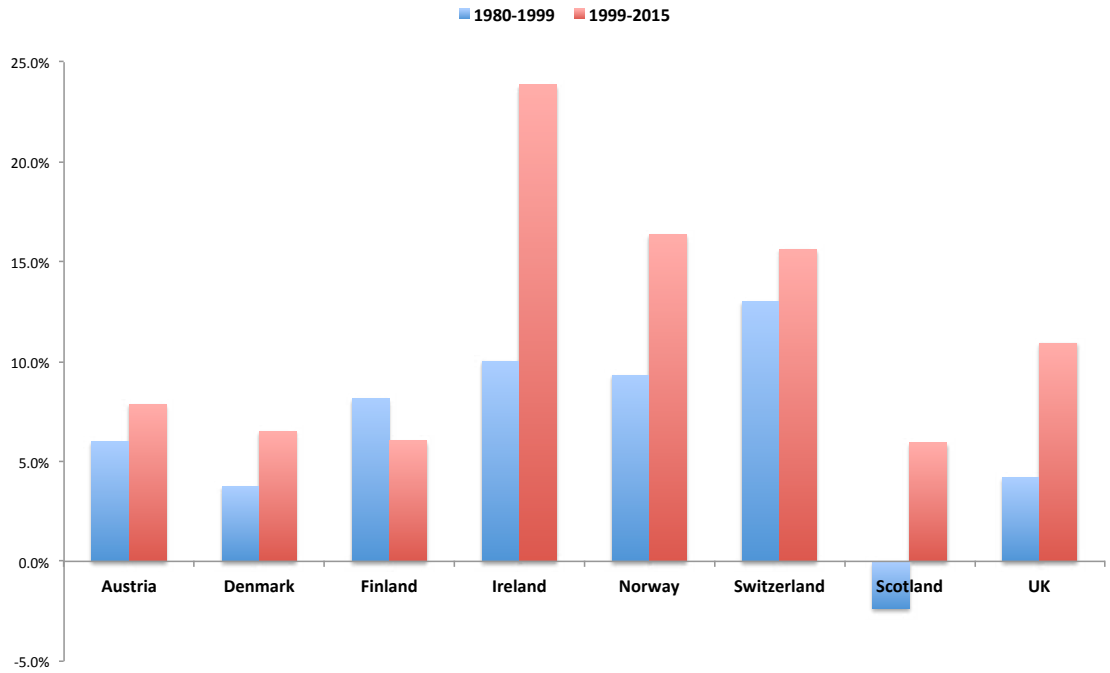
A1.26 The sustainability of growth, both national GDP and GDP per capita is dependent on the particular driver of this growth. Some productivity growth drivers, such as reduced waste and increased human capital are likely to contribute to the sustainability of an economy, while others such as the increased non-renewable resource use may cause problems for the future. We develop these three components and suggest policies to improve performance in the coming chapters.

Population Trends

A1.27 Trends in Scottish population in recent decades provide some insight into economic performance. In the 1980s and 1990s, Scottish population was static or in decline, with a fall in the population of more than 2%. This has been reversed since devolution, with the Scottish population growing by almost 6% between 1999 and 2015 to 5.4 million. However, this has slowed since the financial crisis and is still behind the population growth in the UK and that experienced by successful small advanced economies (Figure 1-3).

A1.28 So, if Scotland had matched UK population growth since 1980, the population of Scotland would now be 5.8 million and if it had matched the population growth of the other small European countries shown in Figure 1-3 there would be 6.1 million living in Scotland.

Figure 1-3 – Population Growth 1980-2015 (Scotland, UK and Selected European Countries



Source: IMF World Economic Outlook Database and National Records of Scotland

Benchmarking Scotland's Economy

A1.29 When Scotland's economic performance is benchmarked, it is often against the UK economy. However, given the long term relative decline in the UK economy and the challenges that it now faces with productivity moribund, regional disparities, inequality and

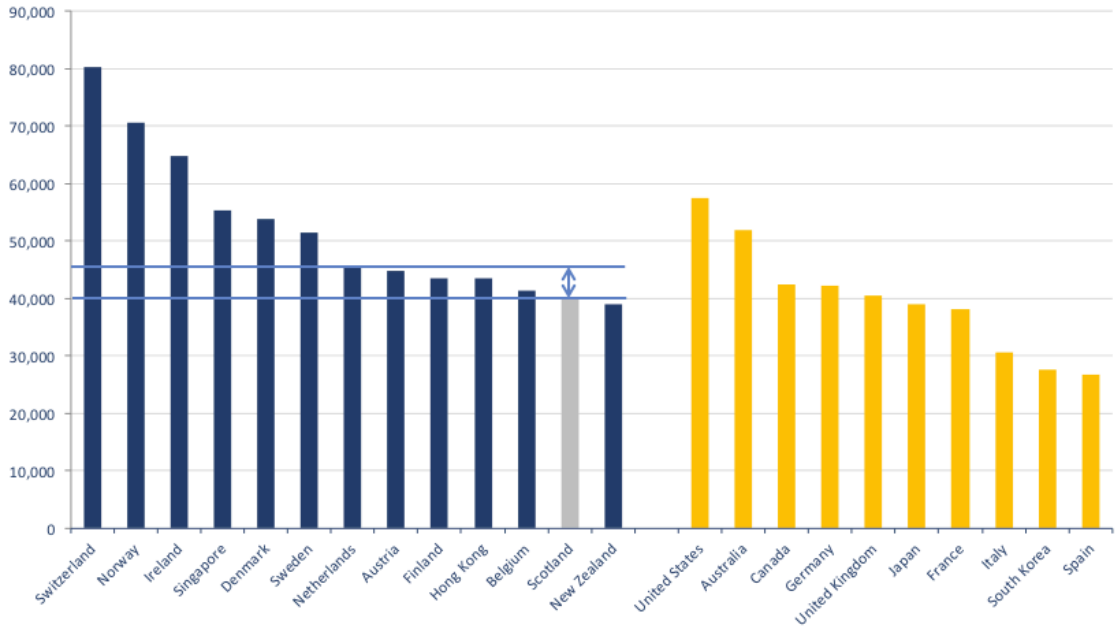
the forthcoming economic shock from Brexit, Scotland would do well to look more broadly be more ambitious and seek to benchmark against better performing economies, as is already done by the Scottish Government's National Performance Framework.

A1.30 An independent Scotland would start as one of the wealthiest countries in the world, with a similar level of GDP per capita as New Zealand, France and Japan (Figure 1-4).

A1.31 However, there is a gap between Scotland's economic performance and that of other small advanced economies. If Scotland were to be added to the list of 12 benchmark small advanced economies, it would be 12th out of 13 in terms of GDP per capita. The median of this group is 14% higher than Scotland, a gap of $5,500 (£4,100).

A1.32 This provides a measure of what Scotland can achieve in the future if it has the same ability to tailor economic policy to its own needs and advantages as these other countries do.

Figure 1-4 – GDP per Capita in Advanced Economies (2016, US $)



Sources: IMF World Economic Outlook Database (April 2018)

Economic Context

A1.33 Scotland's economic performance is, like the UK, amongst the best performing decile in the world economy. That said, while the UK continues to be one of the largest global economies its economic model is one that has struggled to match the performance of many other advanced economies and has seen its position in the economic league tables decline from the wealthiest economy little more than a century ago to 20th now in terms of economic output per capita.

A1.34 The UK model has centralised economic activity in London and the South East, a template that no other large advanced economy has followed. As a result, the disparity in regional

economic performance far greater than any other European country. While London dominates the UK economy, Scotland is close to the average overall UK economic output per person and is well ahead of the North and Midlands of England, Wales and Northern Ireland.

A1.35 The UK economy has also struggled to provide the earnings growth that would deliver rising living standards (which is also likely to be an indicator of slow productivity growth). Real terms average annual employee earnings are still well below pre-crisis levels and are not projected to recover to those levels until the 2020s.

A1.36 And of course the disorderly Brexit process has created significant economic uncertainty. The devaluation of Sterling and the worsening outlook for UK public finances point to the economic shock yet to come which we fear will be material and long-lasting.

A1.37 Furthermore, it is noticeable that the UK economy's dependence of debt financed consumer spending led growth has caused many policy makers including the Bank of England material cause for concern[14].

GDP and GDP per Capita

A1.38 The current discussion on economic growth is chiefly focused on the Gross Domestic Product (GDP) of a country, rather than the well-being that it is supposed to represent. GDP is a measure of the value of all goods and services produced in a country in any given year.

A1.39 The measure of GDP does not take account of the implications of achieving this output. Some of the current contributors to GDP will have negative consequences on the ability for future economic activity to be maintained, such as overuse of natural resources. Therefore, in addition to considering overall economic growth it is important that a focus on the sustainability of this growth is core to strategic thinking. This sustainability would reflect the inclusive nature of this growth, the environmental implications of such growth and the social implications.

A1.40 However, the measure of GDP is important because it is closely related to the amount of money a government has available to spend on goods and services. Taxes are paid on the economic activity that is measured as part of GDP, therefore if the level of national GDP falls this will lead to a lower level of money available to pay for public services.

A1.41 The overall level of GDP in a country is less important to individuals than the level of GDP per capita. This is the total amount of value added per head of population and is an indication of the proportion of the population that is in work and the productivity of those employees.

[14] Bank of England (June 2017), Financial Stability Report

A1.42 The simplest way to understand GDP from its many possible calculations is as a summation of all of the wages/salaries and all of the company profits created in an economy in any one period of time.

Global Economic Context

A1.43 Over the last few decades, the world economy has grown at a real terms annual average rate of 3.5%[15], which means it has doubled in size every 20 years or so.

A1.44 The IMF expects[16] the global economy to continue to grow over the next few years at a rate slightly higher than the long-term trend. The driver of this growth will be the emerging and developing economies, expected to grow by around 5% annually, while the advanced economies are expected to grow more modestly at around 1.75%.

A1.45 This global growth has seen billions of people escape poverty, particularly in Asia, as high rates of economic growth in China, India and other Asian countries have delivered rapid economic development. However, in the post-crisis world there are fewer high growth economies. In 1997, there were 35 countries with economic growth rates of 7% or more, but by 2015 that had fallen to nine countries.

A1.46 The consensus for at least the two to three decades before the financial crisis was that monetary policy was key to macroeconomic demand management, with interest rate policies focused on controlling inflation. At the height of the crisis in 2008, central banks cut interest rates close to zero and then resorted to unconventional monetary policy interventions such as quantitative easing (QE). Interest rates have now been close to zero for almost a decade and fiscal policies have become more prominent as governments have sought to stimulate economic growth.

A1.47 The post-World War Two period was characterised by increased globalisation, an environment in which many small advanced economies prospered as they found niches in global markets as trade barriers were reduced.

A1.48 The financial crisis and its aftermath has also challenged the 1980s US and UK consensus on the role of government. This held that government should create a stable environment and then get out of the way of the private sector and allow it to generate prosperity. A more active role for government has been a feature of many small successful economies and is now being implemented and debated in many larger advanced economies. This includes the UK, which is currently consulting on an Industrial Strategy.

[15] IMF World Economic Outlook (April 2018)
[16] IMF World Economic Outlook (April 2018)

Economic Fundamentals and Long-term Opportunities

A1.49 While we are living through a period of uncertainty globally, there are some long-term trends that we can be confident about and which provide a basis for optimism about global market opportunities for Scotland. These were summarised in a lecture by Professor Graeme Roy of the Fraser of Allander Institute in 2017 and are discussed below.

Rapidly Emerging Markets

A1.50 In 30 years' time, China will be the largest economy in the world by a significant margin, followed by India and Indonesia will rise to fourth. And the growth will not be confined to Asia, Mexico is predicted to be larger than the UK economy by 2030.

A1.51 Scotland currently exports very little to these large and growing economies (Scotland exports more to Ireland than to China and more to Luxembourg than to India) but the demand for quality goods and services from their households as they become wealthier will be substantial and so presents major growth opportunities for Scottish goods and services.

Technological Development

A1.52 Whilst recent decades have been dominated by globalisation the next few seem set to be dominated by exponential technological development, a 4th industrial revolution, driven by communications technologies, robotics, artificial intelligence, nanotechnology, data processing power, 3D printing, the Internet of Things, driverless vehicles and medical breakthroughs.

A1.53 This disruptive time creates many opportunities, from which Scotland is well placed to benefit, given its strengths in many areas of science and technology (including in the universities, as discussed later in this report) and the decreasing importance of physical distance to market.

A1.54 To benefit Scotland will need to continue to invest in digital infrastructure and, crucially, in the digital skills development required to make full use of the new technologies.

Equality and Sustainability

A1.55 These rapid changes will mean challenges that are already apparent. Just as the gains from trade during the age of globalisation did not benefit everyone it is also likely that the gains from technological development will also be unevenly spread. This again emphasises the need to invest in digital skills and also the wider issue of how the economy responds to the loss of jobs driven by technology (including some current high value jobs such as legal and accounting services). Again the education and skills system will have an important role to play since current and future generations are likely to have more than one career during their lives.

A1.56 Other challenges include adapting to an ageing population and climate change. While these are often discussed in terms of social and environmental challenges, they both present opportunities too. Goods and services relevant to older people, supporting healthy ageing, and to adapting to climate change could expect global market opportunities.

UK and Scotland Before Brexit

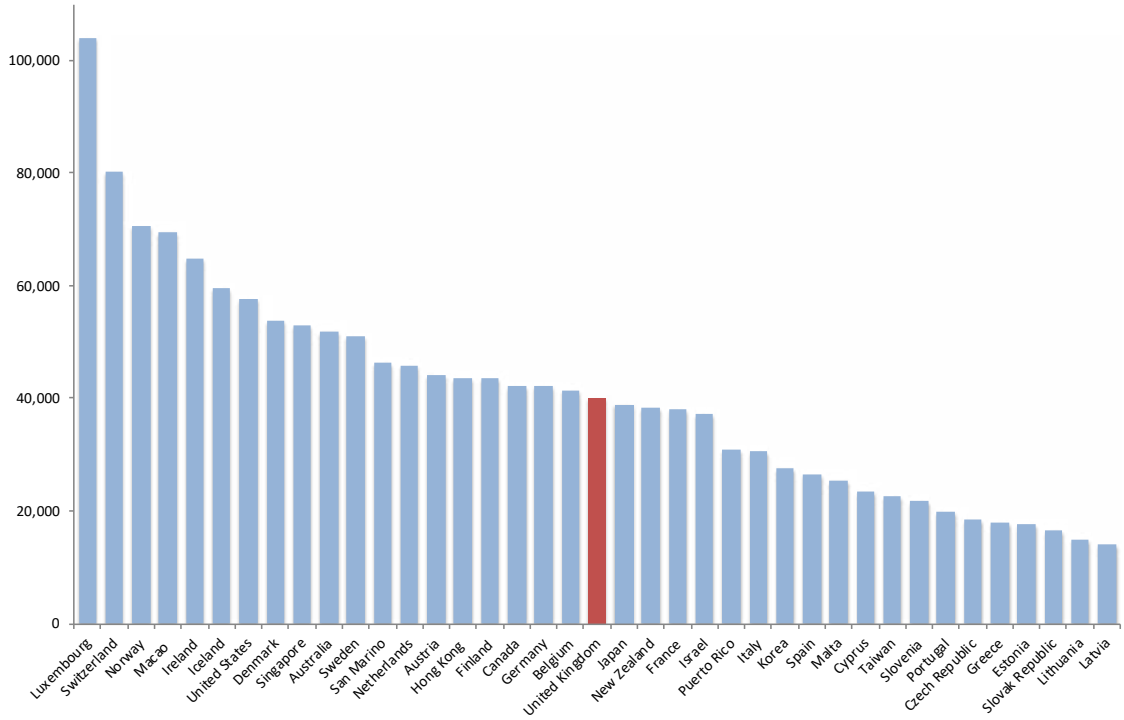
A1.57 While Scotland shares many of the features of a small advanced economy, much of the most important economic management responsibility is reserved to Westminster and Whitehall. Consequently, Scotland is, to a significant degree, subject to a large country economic approach that is not always appropriate to our circumstances. As a large economy, the UK should have a strategy based on spreading risk across sectors and across regional economies so that it is well insulated from economic shocks.

A1.58 However, not only is the UK's large economy approach inappropriate for a small advanced economy such as Scotland, but it has been poorly executed by successive UK governments. The global financial crisis highlighted that the UK had become heavily dependent on financial services, which continue to account for a large proportion of UK Government tax receipts with almost £1 in every £9 collected from banks and other financial institutions[17]. The UK economic is also centralised on London and the South East with high levels of regional disparity and inequality.

A1.59 The UK was the predominant global economic power at the start of the twentieth century - the largest economy in the world in both absolute and per capita terms. The UK remains one of the largest global economies, as the fifth or sixth largest economy (depending on whether historic or current exchange rates are used for the comparison) in 2016, as measured by Gross Domestic Product (GDP). However, in per capita terms the UK is 20th out of the 39 advanced economies (Figure 1-5) having been first a century ago.

[17] PWC for City of London Corporation (December 2016), Total Tax Contribution of UK Financial Services

Figure 1-5 – Estimated 2016 GDP per capita of Advanced Economies ($)



Source: IMF World Economic Outlook (April 2018)

Critique of UK Economic Model

A1.60 The structural problems in the UK economy are well recognised, including in reports commissioned by the UK Government. For example, the problems identified by former Deputy Prime Minister Lord Heseltine in his 2012 report[18] included:

- **The productivity gap**: The UK output per hour worked lags behind countries such as the US, Germany and France.
- **Gross domestic product**: prior to the financial crisis of 2008, UK growth was increasingly driven by the accumulation of unsustainable levels of public and private sector consumption fuelled by debt, greatly outstripping the contributions of business investment and net trade to UK economic growth.
- **Research and development**: While the UK has a strong reputation for world-class research, the UK does less well at translating that into goods and services.
- **Trade in goods and services**: Over the last 30 years the UK's balance of trade and share of global export markets have deteriorated. While the surplus in the balance of trade in services has grown steadily, it has been outgrown by the rise in the trade deficit in goods.

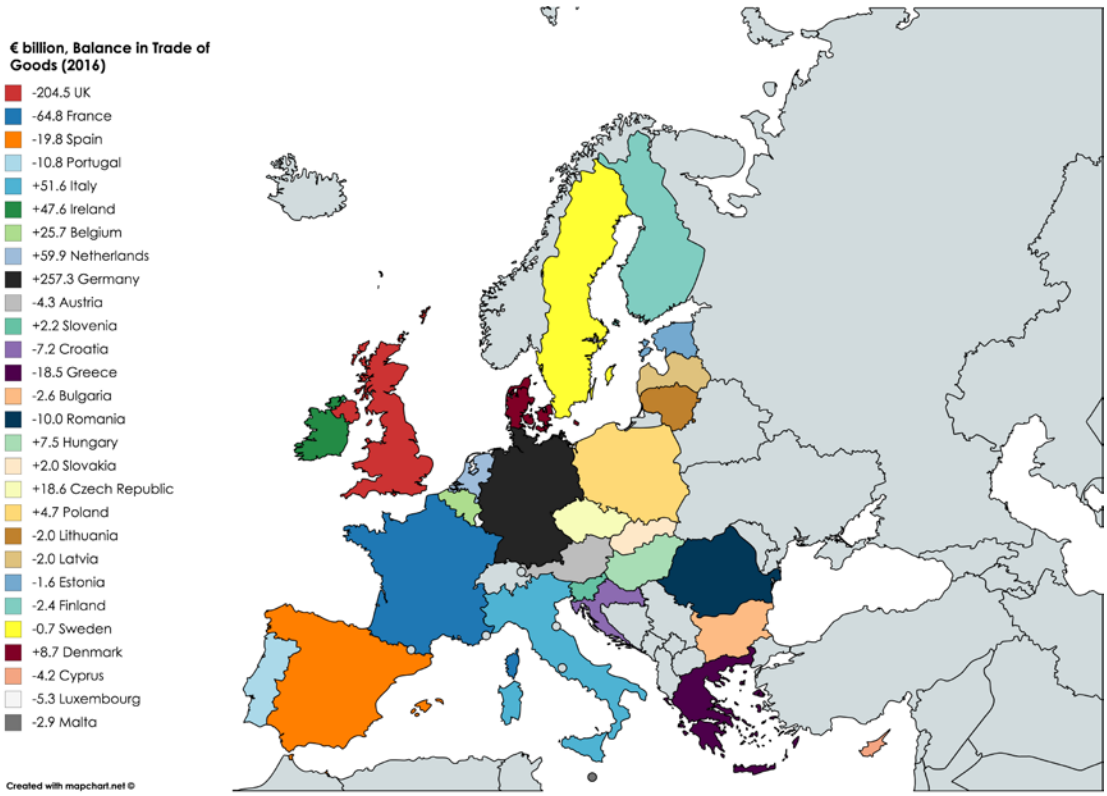
[18] Lord Heseltine (2012), No Stone Unturned

- **Persistent regional disparities**: Despite the efforts of successive governments to address regional disparities, the variation in economic performance across the UK persists. It is not just the relative difference between the contributions of different regions that matters but the ability of all regions to grow their wealth and prosperity.

UK Trade Deficit

A1.61 As Lord Heseltine noted, there has been a decline in UK exports of goods and an increase in imports and while this has been balanced by a positive net balance in the trade of services, the UK's share of the global market is falling. In terms of goods, the UK has by far the highest trade deficit in the EU (Figure 1-6). Brexit is likely to make this difficult situation, even worse.

Figure 1-6 – Trade Balances in the EU in 2016 (Goods, € billion)

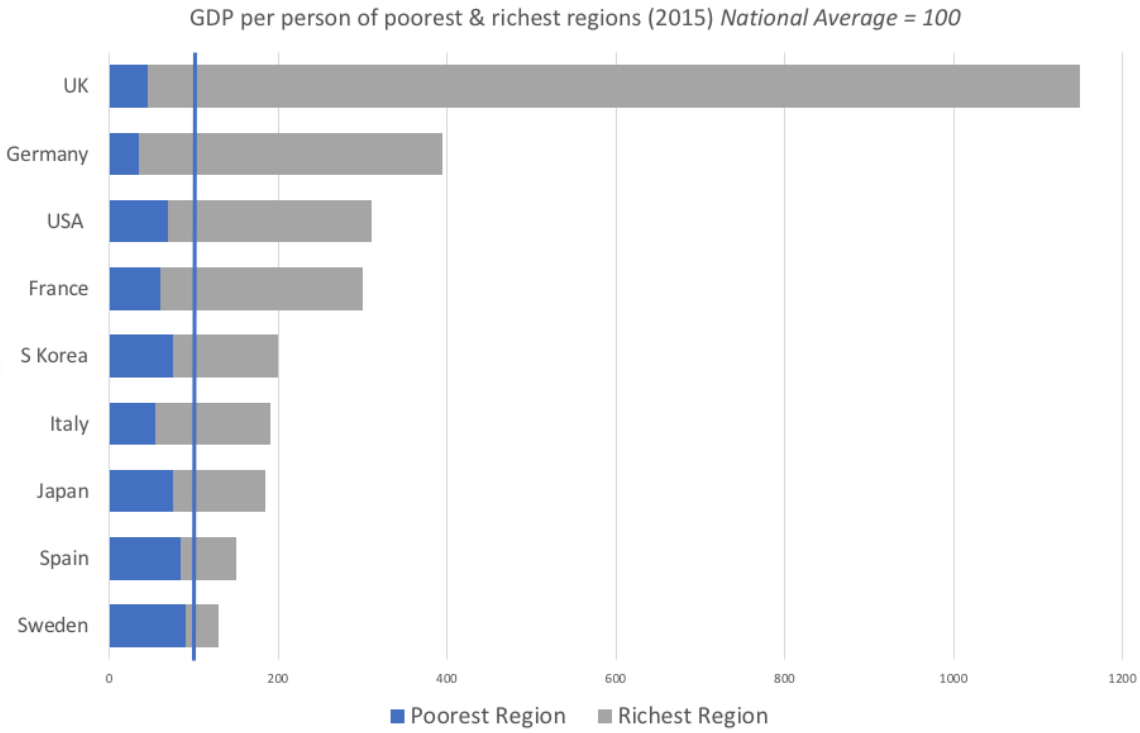


Source: Eurostat, February 2017

UK Regional Disparities

A1.62 The UK has by far the widest distribution of regional economic performance amongst developed economies (Figure 1-7).

Figure 1-7 – Richest and Poorest Regions in Developed Economies



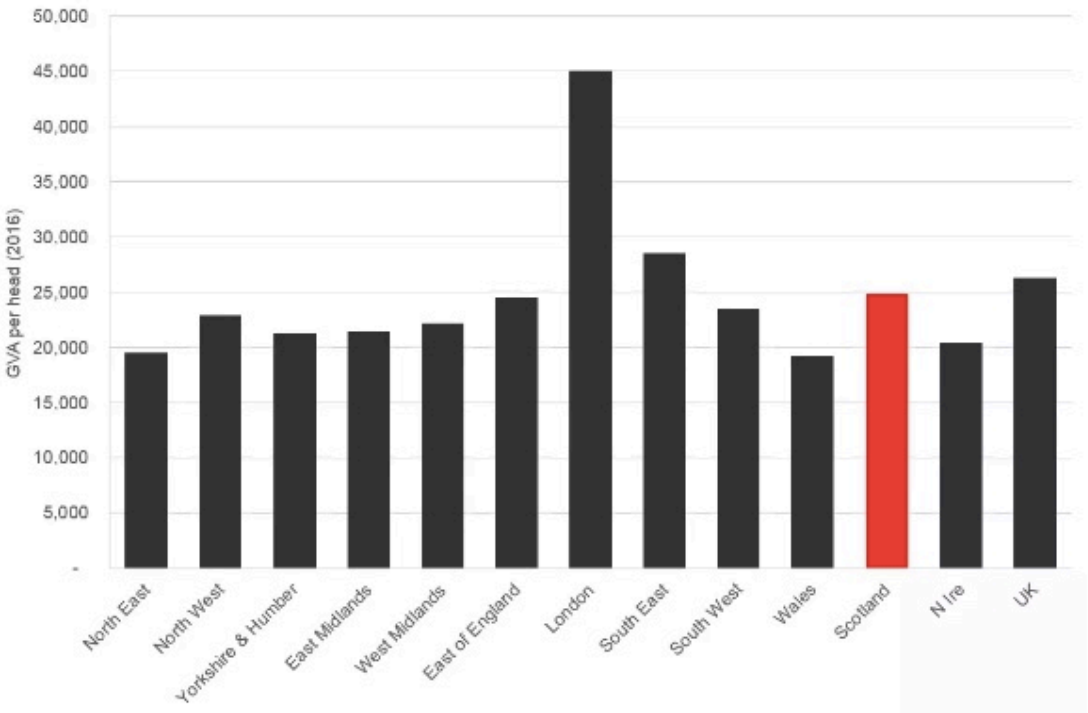
Source: OECD, The Economist (November 2017)

A1.63 There are large disparities in regional economic output in the UK, with economic output (Gross Value Added, GVA) per head in London at around 170% of the average for the UK overall and every other UK nation and region much closer to the national average (Figure 1-8). So, the gap is not between Scotland and the UK as a whole, but between London and all the other nations and regions of the UK, and this is reflected in fiscal performance as well as economic output.

A1.64 Scotland's economic output per head is the best of the UK nations and regions, outside of London and the South East. Some argue that the underperformance of most UK nations and regions is compensated by fiscal transfers from London and the South East. We disagree with the desirability, sustainability and ambition of this position. This is not as good as it gets and the suggestion that the UK will continue to do this long term is unrealistic.

A1.65 We should note at this point that this is a critique of the overall model and is not intended as a criticism of the world city that is London itself. The challenge for Scotland (and other areas) is to balance the benefits of proximity to London and all that goes with it in terms of opportunity, with the negative effects of its gravitational pull on talent, capital and decision making power on the rest of the UK.

Figure 1-8 – UK Regions & Nations Economic Gap (GVA per Head, 2016)

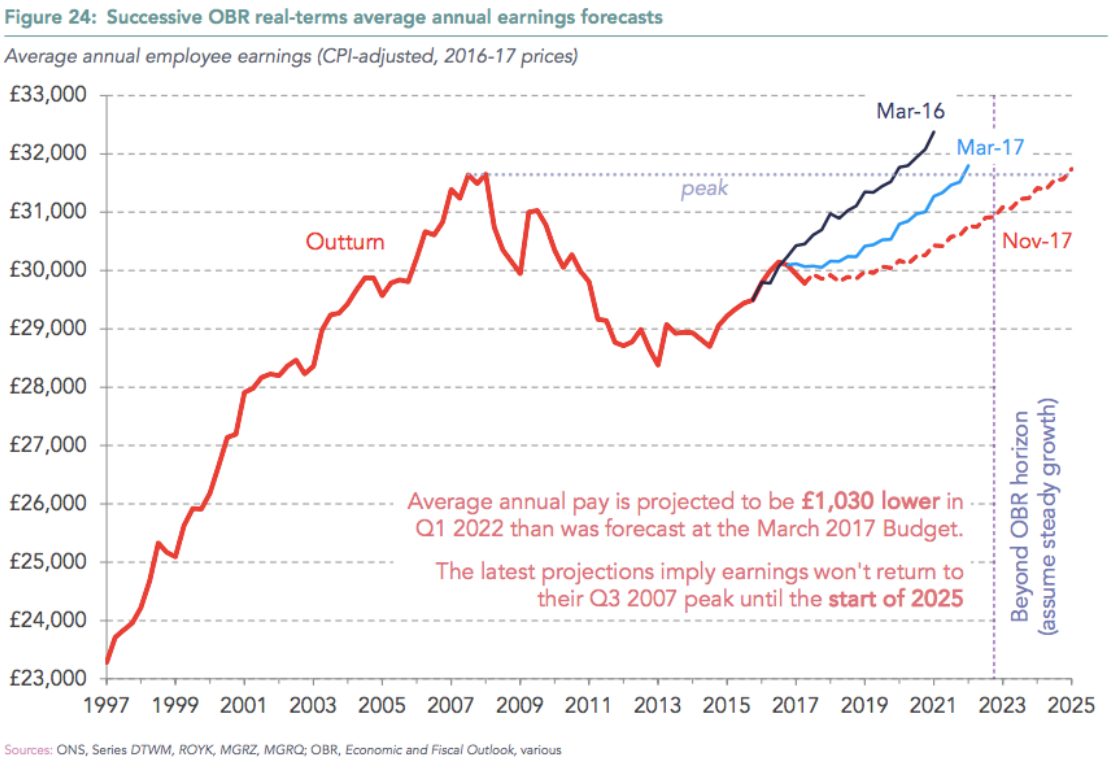


Source: Fraser of Allander Institute, from ONS, Regional GVA 2016

UK Earnings Yet to Recover from Crisis

A1.66 The UK economy is also failing to deliver the earnings growth that would deliver rising living standards. Analysis by the Resolution Foundations finds that real terms average annual employee earnings are still well below pre-crisis levels and are not projected to recover to those levels until the mid 2020s (Figure 1-9).

Figure 1-9 – Average Earnings in UK



Sources: Resolution Foundation (November 2017)

Scotland Constrained by the UK's Big Economy Model

A1.67 Scotland shares many of the characteristics of other successful small advanced economies:

- strong institutions and levels of social capital;
- human capital and knowledge (and world-class research institutions);
- a valuable resource endowment (oil and gas, renewables, food, tourism); and
- proximity to large, prosperous markets.

A1.68 However, Scotland is constrained in developing policies that are specific to the context and potential of Scotland's economy. As part of the UK, it has had a policy framework that is more like that of a large economy than of a small advanced economy. The devolution of powers to date has helped, but it is the overall system that makes the difference – and Scotland is held back from following a 'small economy approach'.

A1.69 Scotland has been subject to the gravitational pull of London without being able to develop policies that would make Scotland a more attractive environment for mobile factors of production – to both manage the risks of London as well as to leverage the potential asset of proximity to London.

A1.70 Many of the policies that Scotland inherits from the UK are more suited to a large economy than a small economy. Shifting towards policy settings and approaches that are more characteristic of successful small economies would generate economic benefit for Scotland. These include:

- a more strategic approach to the economy, targeting policy (including those crucial economic policy areas currently reserved) towards pursuing those opportunities where Scotland can be competitive;
- taking an outward-looking globally-engaged approach;
- being more responsive to new opportunities when they arise and developing institutions to support all of this; and
- enabling greater and better collaboration between government, businesses and all others with a stake in improving economic and social conditions.

Economic Impact of Brexit In UK

A1.71 To date any economic impact associated with Brexit will have been associated with economic uncertainty, given that Brexit has not yet happened. The consequences of this uncertainty will not be apparent for some time since the most likely impact will have been on factors such as decisions to invest, the result of which may not be apparent in economic statistics for months or even years.

A1.72 However, there are already signals of the economic shock to come, including the fall in value of Sterling (increasing the price of imports, both of consumer goods and inputs to UK industry) and the delay in the UK's planned fiscal consolidation.

A1.73 Almost all the projections made for the economic impact of Brexit on the UK economy to 2030 show a significant negative impact (the sole exception being the Economists for Brexit group). The negative economic impact projections range up to 9.5% of GDP, resulting from changes to trade, productivity, foreign direct investment, regulation and migration.

A1.74 HM Treasury's own estimates[19] put the impact at 7.5% of GDP after 15 years, associated with a loss of trade of 24% (with an associated productivity impact of 25%) and a loss of foreign direct investment of 22% by 2030 (with an associated productivity impact of 25%) but assume no impact associated with a reduction in migration.

A1.75 To put this in some context, the 2008-09 recession that followed the financial crisis was the deepest UK recession since the Second World War, with the economy contracting by around 6%. So, HM Treasury is predicting that the impact of Brexit will be higher than the deepest post war recession – and that is assuming no negative impact from reductions in

[19] HM Treasury (2016), MH Treasury analysis: the long term economic impact of EU membership and the alternatives

migration. This is a clear and present danger to the Scottish economy and the future well-being of all. The implications should never be under-estimated.

Economic Impact of Brexit in Scotland

A1.76 Scotland is currently facing an uncertain economic future, with the outcome of Brexit negotiations likely to make a significant difference to Scotland's economic prospects.

A1.77 LSE's Programme of Brexit research[20] suggests Scotland (as well as Wales and Northern Ireland) are already being disproportionately hit by the impact of the Brexit vote.

A1.78 The Fraser of Allander Institute has set out the long term economic implications of Brexit[21]. Its analysis describes how trade opens businesses to new opportunities for exporting and investment and how labour mobility boosts labour supply, helping to increase productivity and address demographic challenges in countries, such as Scotland, with an ageing population. Competition helps efficiency, product specialisation and growth and financial integration deepens and broadens capital markets. All these are expected to be impacted in one way or another by becoming less integrated with the EU.

A1.79 Three scenarios for the future relationship with the EU post-Brexit are modelled: a 'Norway' model, a 'Switzerland' model and a 'WTO' model.

A1.80 All these scenarios show significant negative impacts on the Scottish economy, with the WTO model showing economic output 5% lower than it would be otherwise, 80,000 job losses and a reduction in real wages of £2,000 (Table 1-1).

A1.81 Scottish Government analysis[22] estimates the potential impact at 8.5% of GDP by 2030, £12.7 billion per annum (WTO style relationship), as a result of adverse impacts on trade, productivity, population and foreign direct investment. The economic modelling also forecasts an associated 9.6% real reduction in disposable income.

[20] Regional Economic Impacts of Bexit, Lecture by Swati Dhingra and Henry Overman, 15 November 2017.

[21] Fraser of Allander Institute (October 2016), Long-term Economic Implications of Brexit

[22] Scottish Government (January 2018), Scotland's Place in Europe: People Jobs and Investment

Table 1-1 – Impact of Post-Brexit Scenarios on Scottish Economy after 10 years

	Norway model	Switzerland model	WTO model
Exports of Goods	-12% to -18%	-12% to -18%	-26%
Exports of Services	-11% to -18%	-18% to -22%	-25%
GDP %	2-3% lower	3-4% lower	5% lower
GDP £ compared to 2015-16	£3-5bn lower	£4-6bn lower	£8bn lower
Real wages %	3-4% lower	5-6% lower	7% lower
Real wages (£ full-time earnings)	£800-1,200 lower	£1,200-1,600 lower	£2,000 lower
Employment level	1-2% reduction	1-2% reduction	3% reduction
Numbers of jobs	30,000 jobs lost	30,000 jobs lost	80,000 jobs lost

Source: Fraser of Allander Institute (October 2016), Long-term Economic Implications of Brexit

Growth Aspirations for the Scottish Economy

A1.82 We hope that the lessons set out in this report provide a good basis for specifying a reasonable, ambitious economic aspiration for Scotland. First, the economic performance of small advanced economies provides guidance on what Scotland could achieve.

A1.83 Closing the gap with the small advanced economy group median would mean, in today's values, an additional £22 billion in additional GDP per year and additional £9 billion in annual tax revenues (assuming no change in the proportionate tax take).

A1.84 What seem to be small differences in the long-term trend growth rate make a significant difference over time. This is the economic impact of what Einstein called the 8th wonder of the world – compound interest. At a long-term growth rate of 1.5% (which has been the trend rate for Scotland), it takes almost 50 years for the size of the economy to double. A 2.5% growth rate (the average for small advanced economies) reduces this to 30 years and a 3.5% growth rates cuts it to around 20 years.

A1.85 The aspiration for each of these horizons has been informed by consideration of the small advanced economy experience: the historical precedents are there for sustained improvements in growth rates, and for strong convergence towards the income frontier, and the supporting policy and environmental factors. This group currently has higher levels of per capita income than Scotland and are countries that Scotland can reasonably aspire to match over the next period if it pursues well-judged and tailored economic policies.

A1.86 This 12 small advanced economies in question are listed in Figure 1-10. In a similar way, a benchmark group of 10 large advanced economies is constructed: selected IMF advanced economies with populations of over 20 million people.

Figure 1-10 – Selected Advanced Economies

Small advanced economies

Country	Population	GDP/Cap (USD)
Ireland	4,728,000	70,638
New Zealand	4,844,000	41,593
Norway	5,290,000	74,941
Scotland	5,405,000	39,441
Finland	5,503,000	46,017
Singapore	5,607,000	57,713
Denmark	5,749,000	56,444
Hong Kong	7,410,000	46,109
Switzerland	8,420,000	80,591
Austria	8,815,000	47,290
Sweden	10,120,000	53,218
Belgium	11,352,000	43,582
Netherlands	17,080,000	48,346

Large advanced economies

Country	Population	GDP/Cap (USD)
Australia	24,764,000	55,707
Canada	36,657,000	45,077
Spain	46,333,000	28,359
South Korea	51,454,000	29,891
Italy	60,589,000	31,984
France	64,801,000	39,869
United Kingdom	66,051,000	39,735
Germany	82,713,000	44,550
Japan	126,750,000	38,440
United States	325,890,000	59,501

Source: IMF World Economic Outlook, April 2018 (data for 2017); Scottish Government

Reasons for Scotland's Economic Performance Gap

A1.87 Scotland's growth has been consistently lower than the small advanced economy group average. However, it is reasonable for Scotland to aspire to converge to the growth rates of the small economy group, particularly to the extent that it can pursue economic policies more akin to other small advanced economies and given the range of resources and advantages Scotland enjoys.

A1.88 Finland provides a useful performance benchmark. After a deep recession in the early 1990s following the collapse of the Soviet Union, Finland's innovation-driven growth model generated strong growth rates – frequently above 4% in the 15 years prior to the crisis. The combination of industrial strength (firms like Kone), Nokia and the IT sector, as well as natural resources, was successful. And there was a strong policy focus on human capital, good macro policy, regional integration and social cohesion. The shocks to hit Finland over the past several years have created significant economic costs and will require major structural reform to restore competitiveness. But Finland's strong fundamentals remain intact.

A1.89 Another example of a country that has implemented change is New Zealand, which reformed its economy extensively in the 1980s and early 1990s, placing it on a stronger footing. It has performed well over the past 20 years, including in the post-crisis period, with growth rates frequently above 3%. A significant portion of this growth has been due to growth in hours worked (low unemployment and high participation rates, favourable demographics, and very strong rates of net migration). The economy is still based on

exploiting natural resources, through agriculture and tourism, and its productivity performance is low. But this growth model has worked effectively.

A1.90 Over a medium-term horizon, the economic aspiration for Scotland can be framed around sustaining GDP growth at above-average rates to converge towards the income frontier for small advanced economies.

A1.91 Periods of strong growth in small advanced economies are commonly due to strong growth in exports, such as Sweden and Ireland, currently. The periods of strong growth in small economies, such as the mid-1990s through the mid-2000s, were also due to better engagement with the global economy (e.g. moving into knowledge intensive activities at a time when demand was growing strongly).

A1.92 There are some exceptions, such as New Zealand's migration-driven growth model. New Zealand's net migration is currently running at about 1.4% of the resident population, making a substantial contribution to headline GDP growth. Indeed, despite GDP growth of 3.6%, per capita income growth has been around 0.6%.

A1.93 Scotland has much in common with the other small advanced economies. For example, measures of human capital, research and innovation capability, natural resource endowments, and so on, as well as the quality of its overall policy infrastructure (much of which is shared with the UK, a higher income country). Scotland is also close to large, prosperous markets. Scotland can clearly be a amongst the highest-performing European small advanced economies.

A1.94 However, we argue that Scotland is constrained in terms of developing policies that are specific to its economy. As part of the UK, it has had a policy framework that is more akin to a large economy than to a small advanced economy. The devolution of responsibilities to date has helped, but it is the overall system that makes the difference – and Scotland is held back from following an approach more suited to our size.

A1.95 For example, Scotland has been subject to the well-rehearsed gravitational pull of London without being able to develop policies that would make it a more attractive environment for mobile factors of production, not least labour and talent – to both manage the risks of London as well as to leverage the potential asset of proximity to London. The UK Government has argued against a differentiated model for Scotland in the event of Brexit and has opposed the devolution of immigration powers.

A1.96 This reality has implications for both the nature of the economic policy agenda that Scotland should adopt as well as for a reasonable growth aspiration for the country.

GDP Growth Objectives

A1.97 It is an appropriate aspiration to aim for the top half of the per capita income league rankings. Currently, this aspiration would position Scotland alongside the Netherlands and

close to the other small countries that can be treated as particularly useful peers for Scotland. This long-term aspiration is a useful anchor for the overall economic growth process.

A1.98 The aspirational targets are specified in relative terms (relative to the small economy peer group). This means that the target can adjust to a changing economic context: a stronger economic outlook that leads to stronger small economy performance will lead to a more ambitious aspiration for Scotland (and vice versa).

A1.99 The aspiration is specified over three time horizons. In the first, shortest time horizon (over the next 10 years), the aspiration is framed in terms of converging to the small economy growth rate average. In the second, medium-term, horizon (10-25 years), the aspiration is specified in terms of convergence or catch up growth relative to Scotland's small economy peers. And the third, long term, horizon (25 years plus) is to reach a target per capita income position.

A1.100 The immediate objective for Scotland should be to converge to the GDP growth rates of the small advanced economy group (approximately 2.5%). Scotland's growth rate is forecast to be around 1.2-1.6% from the present year until 2020 according to the Fraser of Allander Institute[23] and between 0.4-1.1% to 2022 according to the Scottish Fiscal Commission[24]. Scotland should aspire to incrementally increase the growth rate throughout the subsequent decade, closing the growth gap and attaining a 2.5% growth within a decade.

A1.101 Following the attainment of a 2.5% growth rate, Scotland should target incremental increases in the growth rate through the subsequent decade to reach a 3.5% growth rate. Achieving this would mean that throughout this period, Scotland's economy would be growing at a greater rate than the small economy group.

A1.102 The long-term objective for Scotland, should be to reach and maintain the median GDP per capita of the small advanced economy group.

Conclusion: purposeful, consistent, longer term strategy required and can deliver

A1.103 Taken together the evidence therefore suggests that we are best to work to a relatively balanced outlook and ambition that nonetheless sees Scotland aspire to become one of the most successful small advanced economies in the world over the next generation and more.

[23] Fraser of Allander Institute Economic Commentary (June 2017)

[24] Scottish Fiscal Commission (December 2018), Scotland's Economic and Fiscal Forecasts

A1.104 The prize in achieving this will be a transformation in living standards across the country. That it is a long-term strategy should not diminish it one bit. We have to begin the process now and the contribution this makes to future generations will be remarkable.

A1.105 Growth targets should be set for the long term and reported against. There should be a three phase approach: (i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.

The Sustainable Growth Commission

A2 INSIGHTS ON THE PERFORMANCE OF SMALL ADVANCED ECONOMIES

- Common themes in benchmark small advanced economies policy include a commitment to strong policy foundations (solid macro policy settings, innovation and human capital, and internationalisation), as well as a high degree of strategic coherence across these different policy settings, positioning the country to compete effectively in the global economy.
- Small economies perform better than larger ones consistently by around 0.7 percentage points per year over the last 25 years on average.
- This growth performance has meant the benchmark group of 12 small advanced economies held its share of the global economy over past decades remaining competitive even with the integration of the large emerging markets. The share of many large economies, including the UK, has retreated substantially.
- Small advanced economies have done well in terms of labour market performance, with relatively low unemployment, on average, a couple of percentage points under those of larger advanced economies.
- On average, there is no clear margin between small and large advanced economies in terms of levels of labour productivity which is constrained in small economies by the small size of the domestic market; the strong performance in the trading sectors offsets this. In this respect leaving the EU and Single Market would obviously act as a growth restraint for Scotland.
- Small advanced economies also tend to do well on measures of the extent to which the gains from growth are broadly shared. Many small advanced economies, notably those in Northern Europe, have low levels of income inequality. Income distribution outcomes are a matter of policy choice, rather than anything intrinsic to small advanced economies.
- The overall performance of our benchmark group is significantly ahead of the UK and the large economies. Policy making is more agile and of higher quality because it requires to be.
- Through history, there has been a strong relationship between periods of trade openness and an increase in the number of countries. Over the past 100 years, the number of independent countries rose from under 70 to just under 200 today.
- Overall, small countries have effective, responsive governments, with a well-developed sense of strategic capacity, high levels of trust and social cohesion, and the ability to adapt in response to changing international circumstances.
- Small competitively-strong economies are continuing to invest in key sectors and clusters, to help them develop positions of advantage in a more competitive and challenging global economy.

A2.1 The experience of small advanced economies provides valuable insight to and guidance for the economic prospects for Scotland, the nature of a high-quality Scottish economic growth agenda, as well as the calibration of an ambitious, reasonable economic aspiration for Scotland. This group of small advanced economies has many similar challenges, opportunities, exposures and intrinsic characteristics as Scotland, and is an appropriate comparator group.

A2.2 This chapter describes the economic growth record of small economies over the past several decades, relative to their large economy counterparts. Specific attention is paid to the post-crisis experience of small advanced economies and what this suggests for the small economy outlook. It considers key reasons for the strong performance by small economies. As part of this analysis Scotland's economic performance over the past 15 years is benchmarked against the small advanced economies group and lessons for the future are discussed.

A2.3 This chapter describes the common themes in economic policy strategy in high-performing small advanced economies. These include a commitment to strong policy foundations (solid macro policy settings, innovation and human capital, and internationalisation), as well as a high degree of strategic coherence across these different policy settings, positioning the country to compete effectively in the global economy. Based on the international small economy experience, it provides a foundation for a Scottish strategic policy agenda to strengthen the country's economic performance.

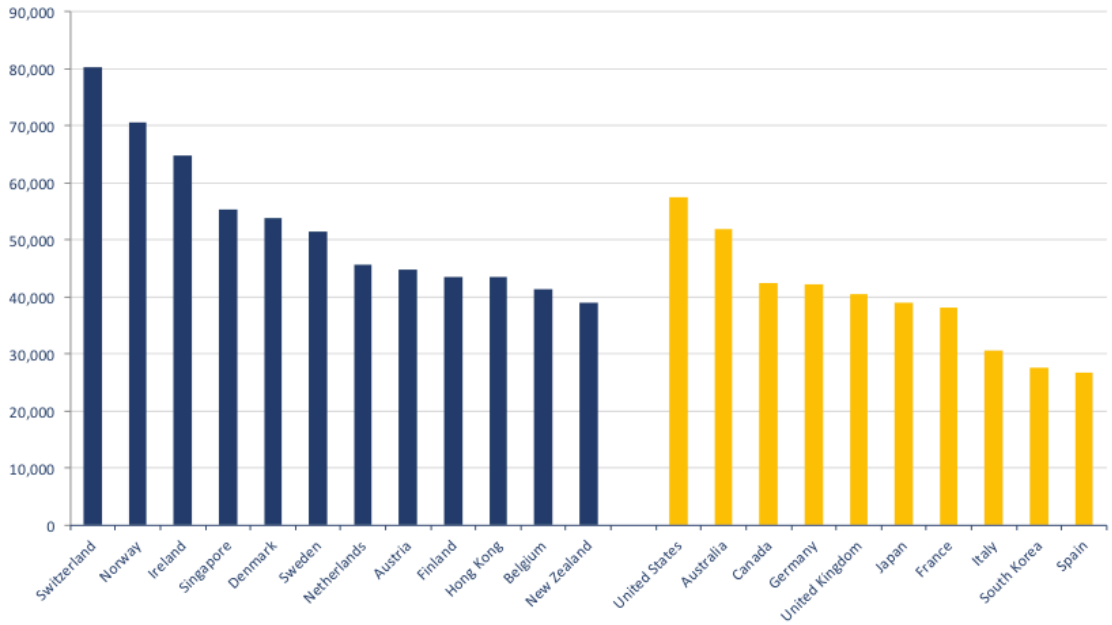
Historical Performance

A2.4 Small advanced economies have performed strongly over the past several decades, and particularly so over the past 25 years. This has been a period of intense globalisation that has supported active international expansion by many small advanced economies.

A2.5 The first observation to make is that small advanced economies tend to have relatively high levels of per capita income, and a few small advanced economies have particularly high levels – such as Switzerland and Norway (Figure 2-1). Although there is clearly a significant distribution of income levels across the small advanced economies group, the top-performing small advanced economies dominate the rankings: countries such as Denmark, Sweden and Ireland rank strongly.

Figure 2-1 – Strong Advanced Economics have strong per capita income performance

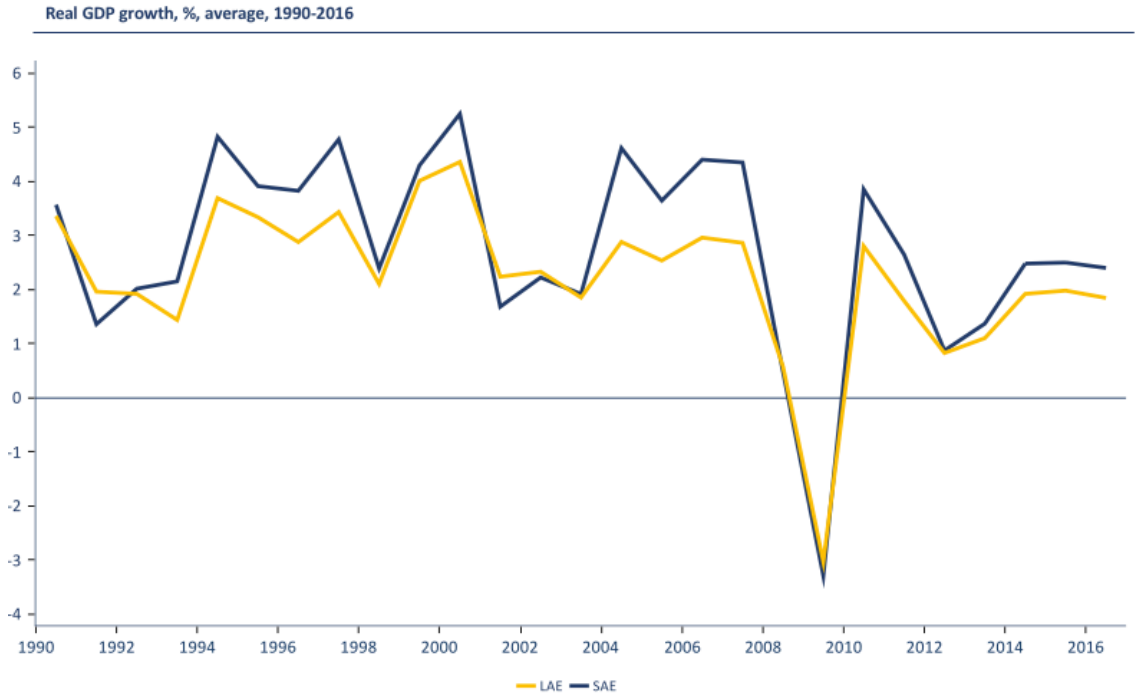
Real GDP per capita income, US$, 2016



Source: IMF World Economic Outlook, April 2018

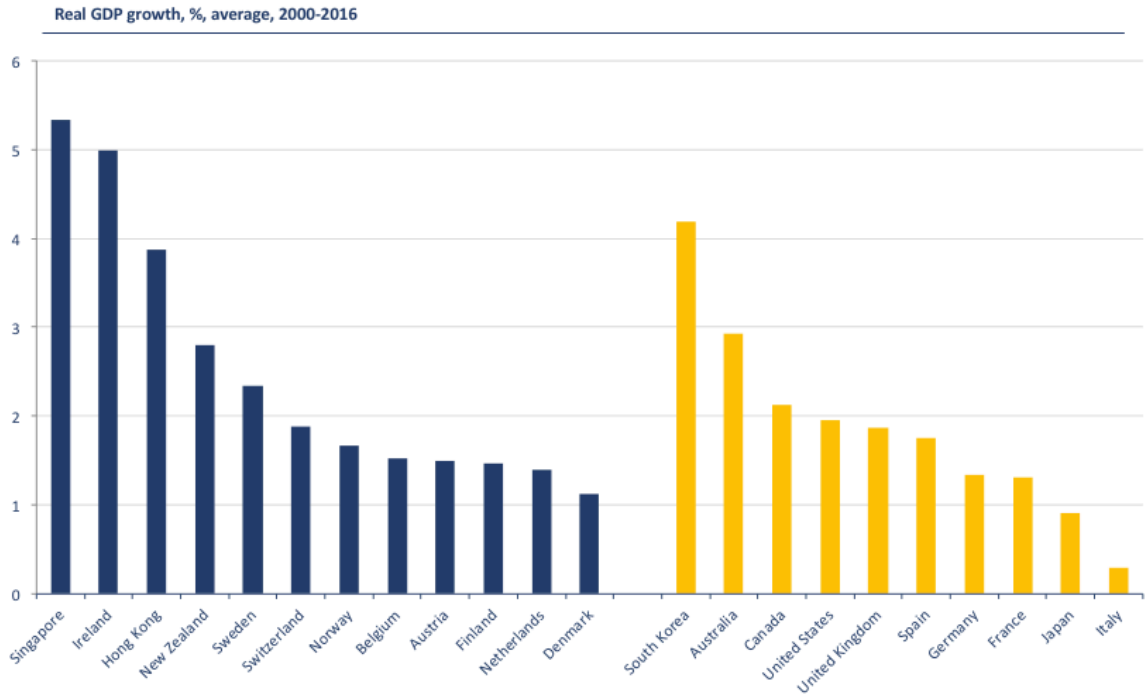
A2.6 These strong per capita income measures are the result of strong small country GDP growth rates over the past few decades. Figure 2-2 shows there has been a distinctive edge of around 0.7% of GDP growth in small advanced economies over the past 25 years relative to their larger counterparts. This strong performance has been broadly-based across the small advanced economies group (Figure 2-3), although several small Northern European economies have generated sluggish growth performance since 2000 (notably Denmark, Finland, and the Netherlands). But some small countries, such as Ireland and New Zealand, have generated strong growth over this period.

Figure 2-2 – Small advanced economies have consistently out-grown large advanced economies, particularly over the past 25 years



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

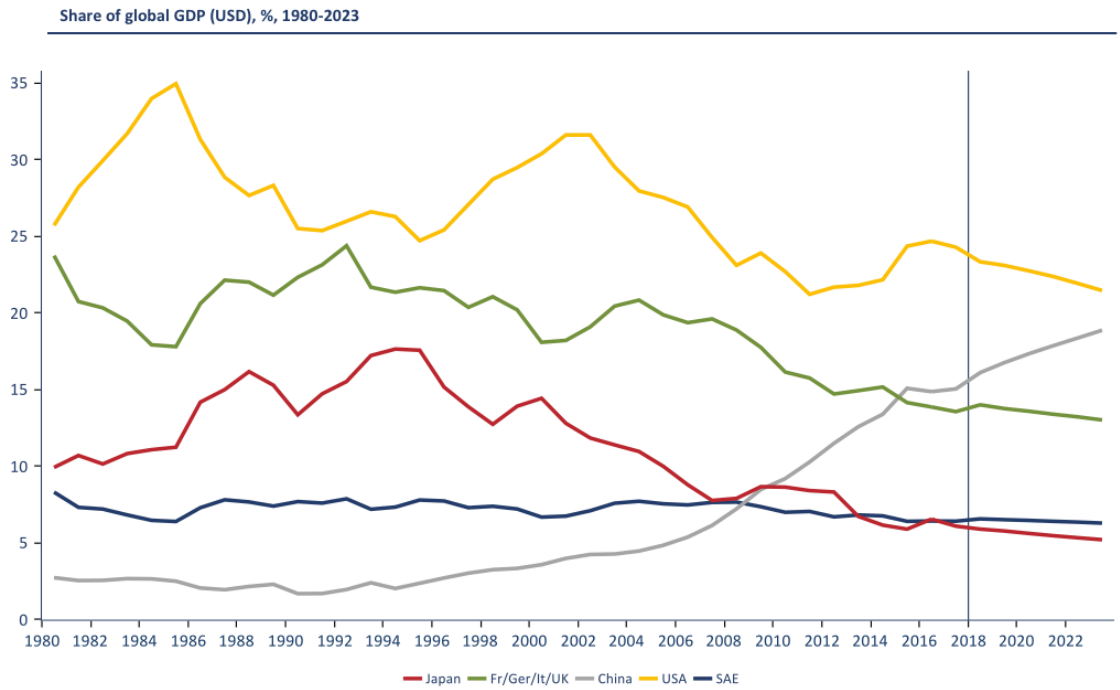
Figure 2-3 – This strong growth performance by small advanced economies has been fairly broad-based, and with some very strong performers



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

A2.7 These growth rates mean that, as a group, small advanced economies have held their share of global GDP constant over the past few decades (Figure 2-4). Small economies have remained competitive even with the rapid integration of large emerging markets into the global economy, even as the global GDP share of many large economies (including the UK) has retreated substantially.

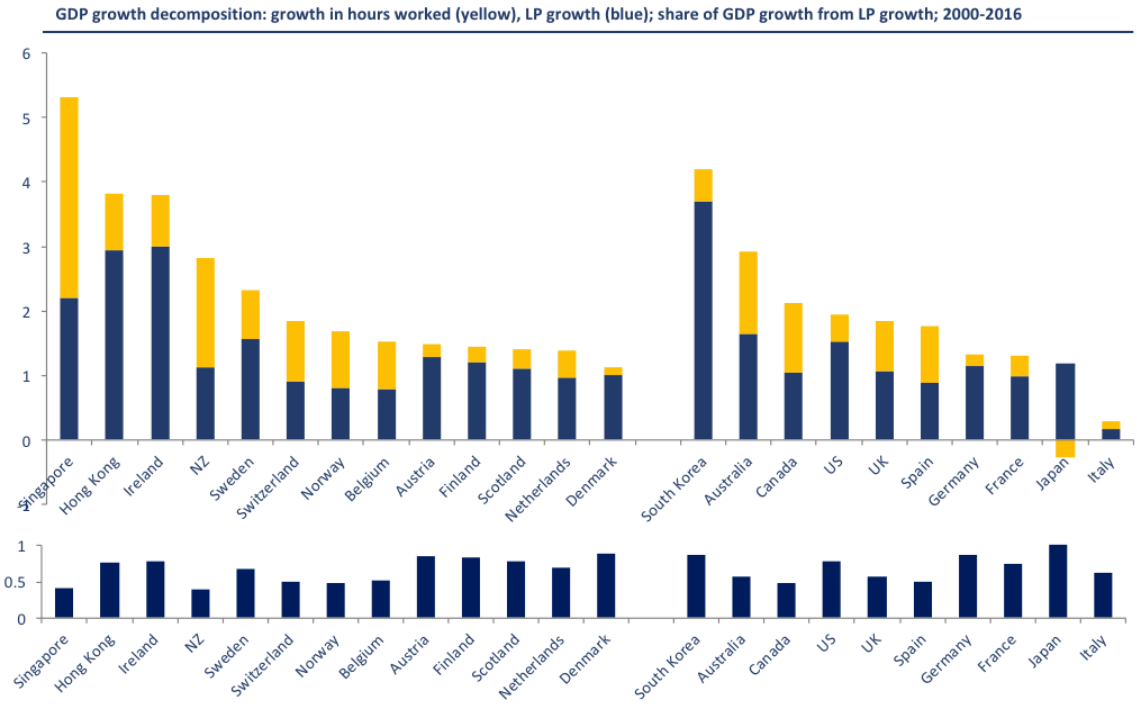
Figure 2-4 – Small advanced economies have held their share of GDP constant over the past few decades; many larger economies have declined



Source: IMF, World Economic Outlook, April 2018; Landfall Strategy Group calculations

A2.8 It is also instructive to look at the variation in growth models across countries. Figure 2-5 notes the contributions from labour productivity and hours worked to GDP growth over the past 15 years. For example, some strong growth countries such as Singapore, Hong Kong and New Zealand have benefited from strong growth in the labour input; other countries like Ireland have also benefited from strong productivity growth, importantly driven by the multi-national companies that have invested. The overall insight is that, for many small advanced economies, labour productivity growth has been a key growth engine.

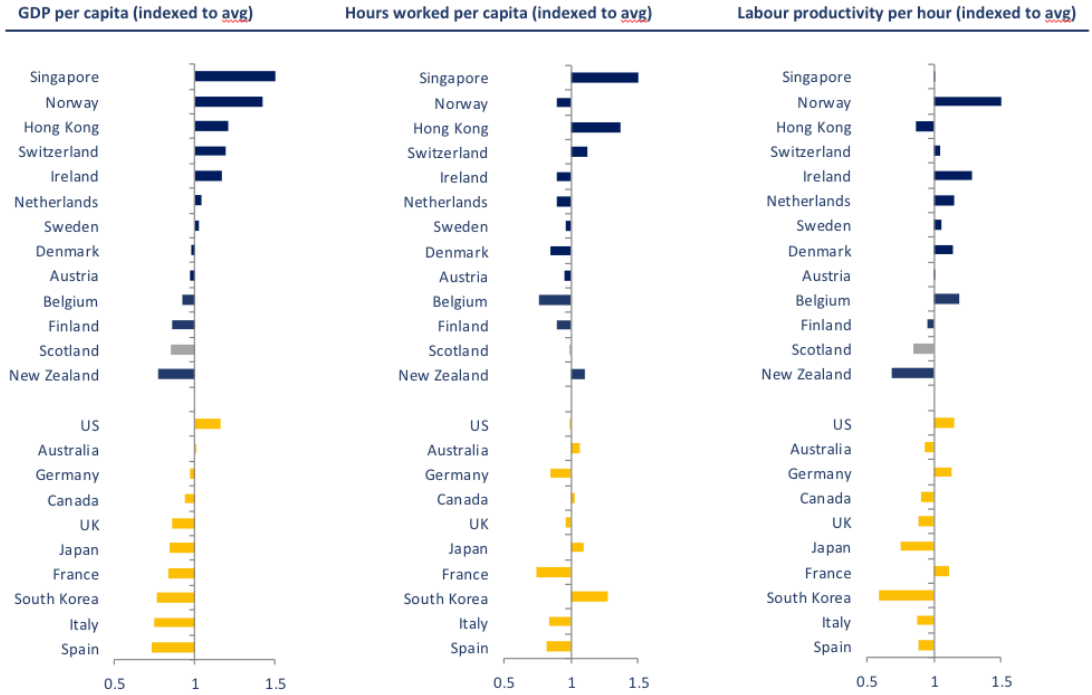
Figure 2-5 – There is significant variation in the productivity contribution to GDP growth across the small advanced economies group



Source: The Conference Board Total Economy Database, May 2017; Landfall Strategy Group calculations

A2.9 Figure 2-6 breaks down per capita income levels into its two component parts: hours worked per capita and labour productivity (per hour worked). There is significant variation across the group. Some small advanced economies, such as Singapore, and New Zealand, rely primarily on high hours worked to support their per capita income levels, with relatively low levels of labour productivity. In contrast, many of the more mature small economies in Europe, such as the Nordics and the Netherlands, have a relatively strong contribution to per capita income from labour productivity. The UK is slightly below the advanced economies average in hours worked as well as the level of labour productivity.

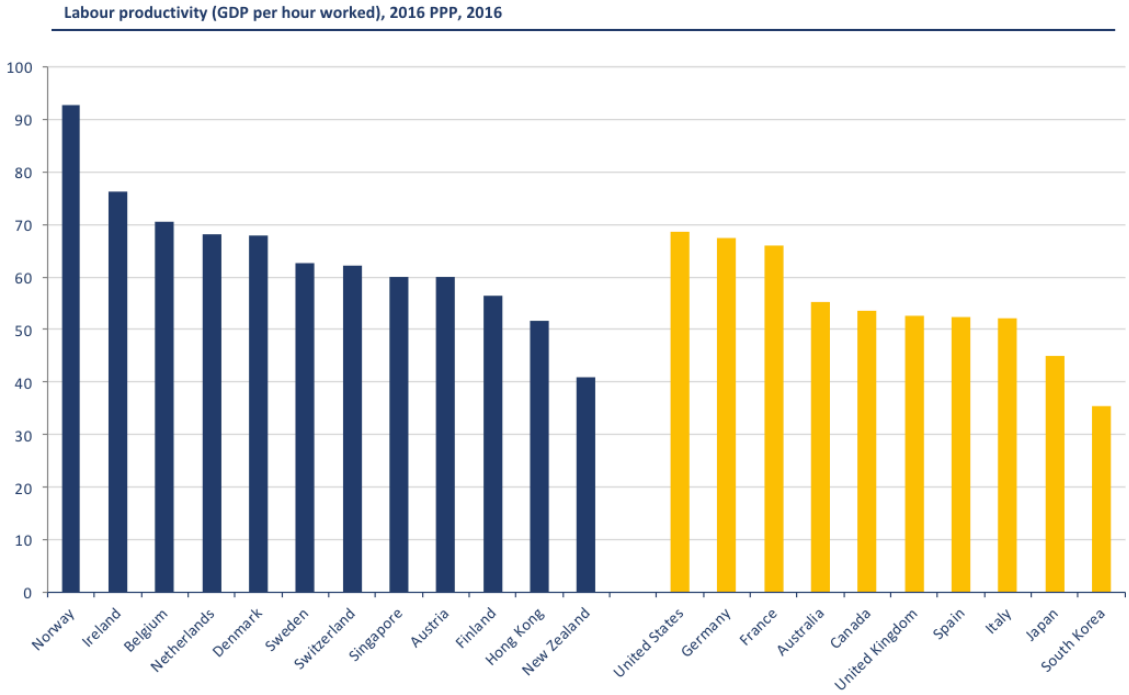
Figure 2-6 – There is variation in small country growth models; but most small European economies have strong labour productivity contributions



Source: The Conference Board Total Economy Database, May 2017; Landfall Strategy Group calculations

A2.10 On average, there is no clear margin between small and large advanced economies in terms of levels of labour productivity (Figure 2-7). Labour productivity is constrained in small economies by the small size of the domestic market; the strong performance in the tradables sector has offset this.

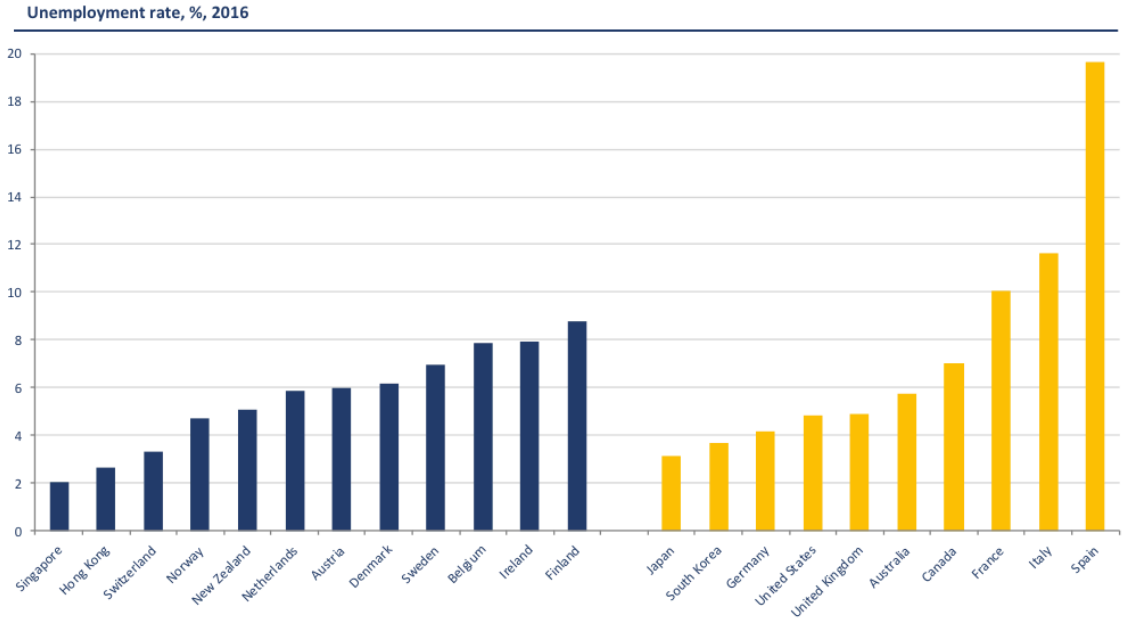
Figure 2-7 – Many small advanced economies have high levels of labour productivity, although the average is similar to large economies



Source: The Conference Board Total Economy Database, May 2017; Landfall Strategy Group calculations

A2.11 However, small advanced economies have done well in terms of labour market performance, with relatively low unemployment and high participation rates. On average, unemployment rates across the small advanced economies group have tracked consistently under those of larger advanced economies by a couple of percentage points. Figure 2-8 describes the 2016 unemployment rate across the advanced economies group which is slightly skewed by the unemployment legacy of the crisis in small countries such as Ireland and Finland.

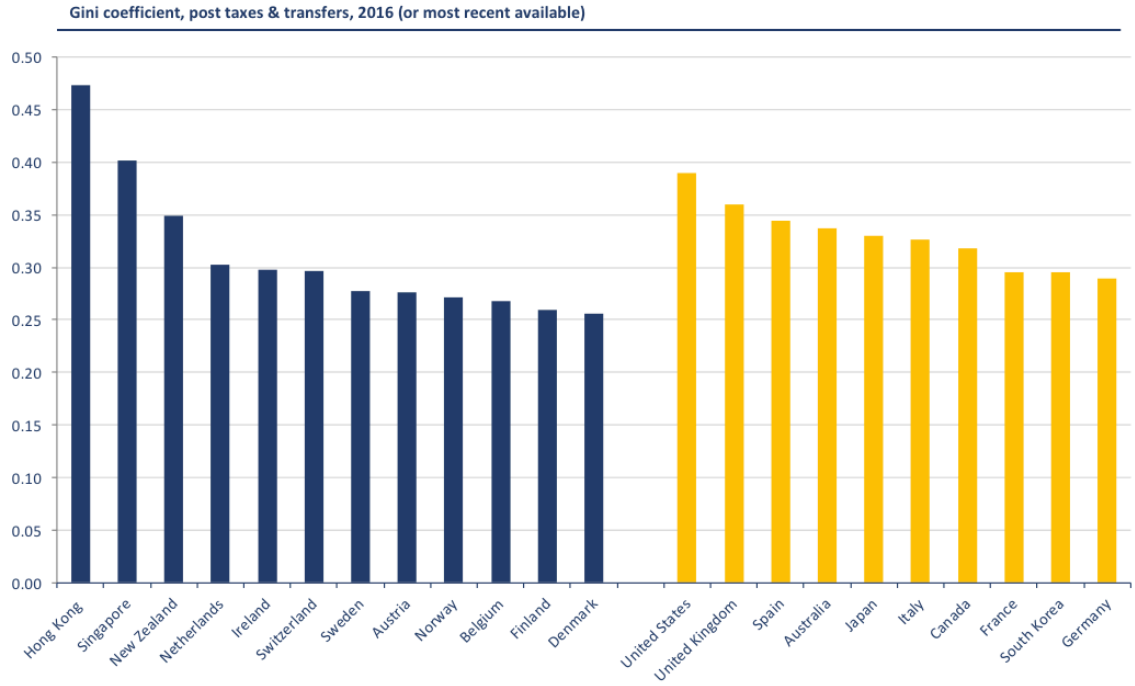
Figure 2-8 – Several low GDP growth economies record relatively low rates of unemployment, but there is a broad distribution



Source: IMF World Economic Outlook, April 2018

A2.12 In addition to these headline measures of economic performance, small advanced economies tend to do well on measures of the extent to which the gains from growth are broadly shared. Figure 2-9 notes the income distribution across advanced economies. Many small advanced economies have low measures of income inequality, notably in Northern Europe, although countries such as Singapore and Hong Kong have high measures of income inequality. Income distribution outcomes are a matter of policy choice, rather than anything intrinsic to small advanced economies.

Figure 2-9 – There is a broad range of income inequality outcomes: some are low (the Nordics) while some are high (Singapore & Hong Kong)



Source: OECD; official sources

A2.13 Of course, not all small advanced economies have performed well. One important characteristic of small advanced economies is that their GDP growth trajectory tends to be more variable. A lesson therefore is to be aware of exposure to externally sourced volatility and plan accordingly.

A2.14 Overall, small advanced economies have out-performed their larger economy counterparts over the past 25 years. They are competitive, innovative and dynamic – and generate good social outcomes. They have been responsive and agile in response to shocks and have been well adapted to the period of intense globalisation over the past few decades. However, although small can be beautiful, small countries have limited margin for policy error.

Drivers of Success

A2.15 So, why have small countries tended to perform better than large countries over the past few decades, a finding that runs counter to conventional wisdom? This chapter considers three explanatory factors: the nature of the external environment; the intrinsic characteristics of small countries; and policy choices made by small country governments

Positive External Environment

A2.16 The global economic and political environment since the end of the Second World War has been much more supportive of small country performance than have previous periods of history. There has been an active process of globalisation, supported by multilateral

institutions like the GATT and the WTO, national decisions to remove barriers to trade and capital flows, strong global growth (most recently from emerging markets), as well as by innovations in information and communications technology.

A2.17 Indeed, over the past several decades, global growth in exports of goods and services, as well as cross-border flows of capital, have significantly out-paced global growth in GDP. And there has been a particularly intense phase of globalisation in the post-1990 period.

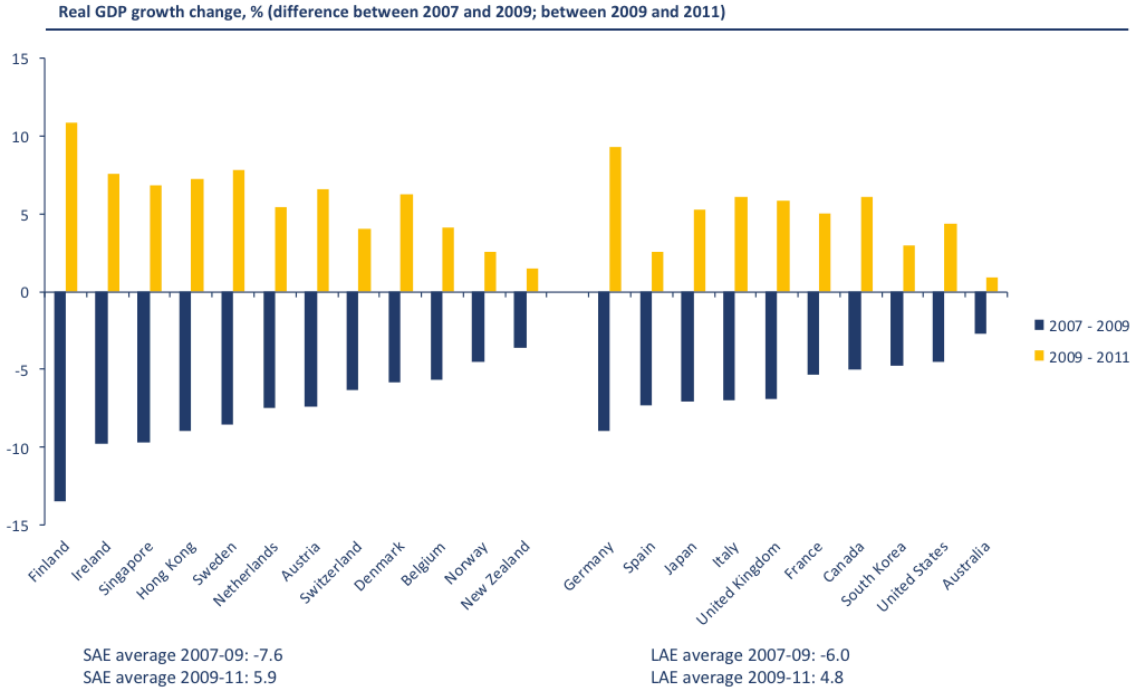
A2.18 This has enabled many small countries to overcome the constraints of a small domestic market by integrating into the global economy. Although geography and national borders still matter, improvements in access to foreign markets have had a positive effect. Indeed, small countries have been very active globalisers. It is hard to imagine the success of small advanced economies without this favourable external environment.

A2.19 In addition, small countries have benefited from a relatively benign global political environment in which being small does not create major security risks. Taken together, this period of economic openness and political stability creates a supportive environment for small countries.

A2.20 One useful measure of this is the increase in the number of new countries. Indeed, through history, there has been a strong relationship between periods of trade openness and an increase in the number of countries[25]. And over the past 100 years, the number of independent countries rose from under 70 to just under 200 today (Figure 2-11).

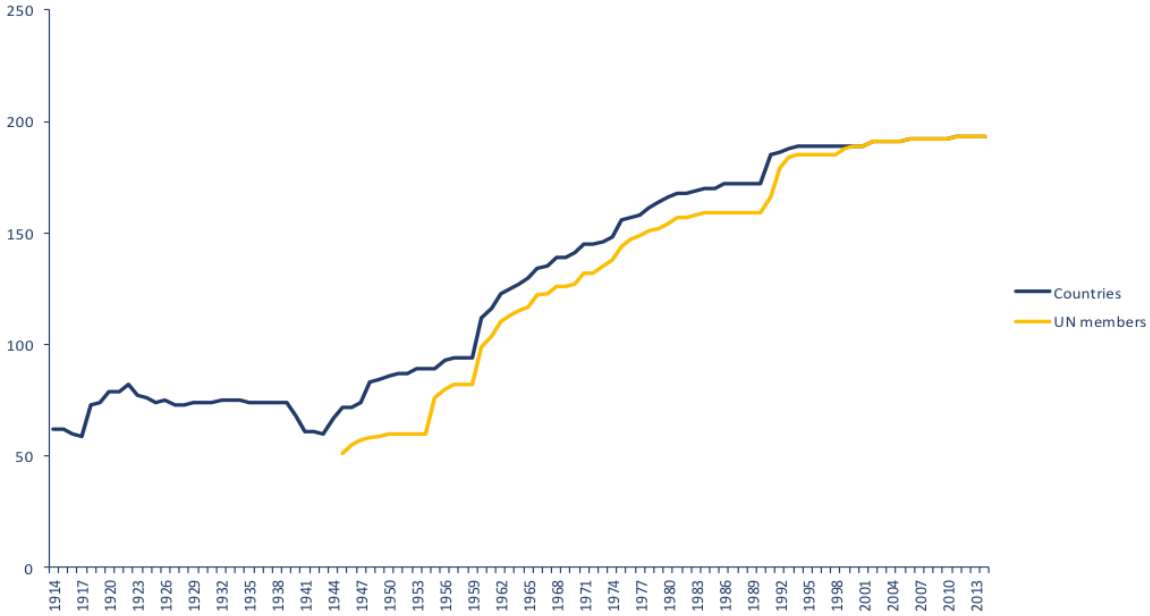
[25] Alberto Alesina and Enrico Spolaore, The Size of Nations, The MIT Press, 2003.

Figure 2-10 – Many small advanced economies experienced a marked slow-down in growth rates during the global financial crisis



Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

Figure 2-11 – The number of independent states has increased sharply over the past 100 years, rising from about 70 to just under 200 today



Source: UN; www.wikipedia.org; Landfall Strategy Group calculations. Note: Since 2000, UN membership is treated as providing the upper bound on the number of independent states

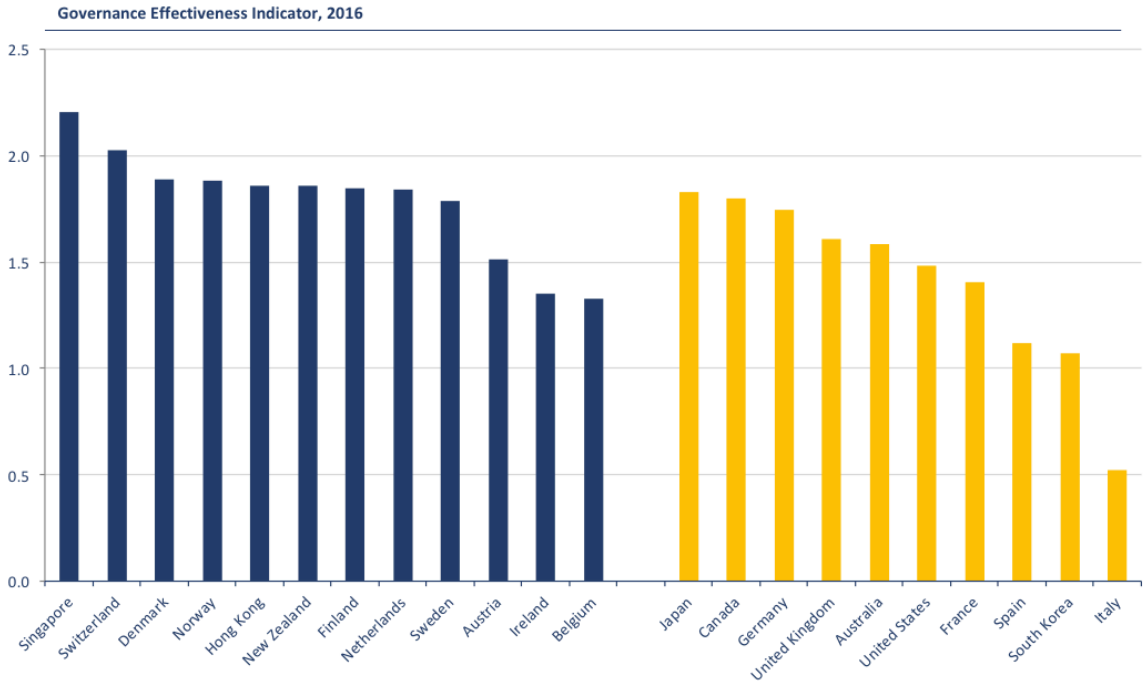
A2.21 The ability of small countries to benefit from the process of intense globalisation has been varied, which also helps explain some of the variation in performance across the small economy group. For example, the challenging physical location of countries like New Zealand created challenges with respect to regional and global integration, whereas Singapore and Switzerland were well-placed to benefit.

Domestic Intrinsics

A2.22 Many small countries also benefit from domestic characteristics that make it easier for them to adapt to a changing external environment.

A2.23 First, the international rankings consistently show that small country governments have higher quality, more effective government institutions. For example, nine of the top 10 countries on the Government Effectiveness measure from the World Bank's Governance Indicators Project are small countries (Figure 2-12).

Figure 2-12 – Small advanced economies have high levels of government effectiveness



Source: Worldwide Governance Indicators, World Bank (www.govindicators.org). This captures measures of government effectiveness such as perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

A2.24 Small country governments also seem to find it easier to organise themselves in a structured and coherent way around a national strategy. It is more difficult to conceive of a coherent national strategy for a country the size of the US or the UK. The policy conversations that are common in small countries have a more deliberate, strategic feel than those in large countries. Indeed, many large countries sometimes seem to be too big and complex to

manage effectively, particularly in a world of disruptive changes. Small countries seem to have a sense of shared purpose, which makes it easier to sustain a policy direction as well as to respond flexibly to change.

A2.25 Second, small countries are regularly at the top of the global rankings of social capital and trust. The World Values Survey reports markedly higher levels of general social trust in small countries than in large countries. And academic research indicates that countries that have higher levels of trust are better able to make good policy decisions and to generate stronger outcomes.

A2.26 Lastly, small countries tend to be more responsive: they have good capability to learn, adjust and adapt to changing international circumstances. This may be because small countries tend to have an acute sense of their exposure to the external environment. External economic and political forces impact more forcefully and rapidly on small countries than on large ones, and so small country policy agendas and national discussions tend to be more focused on responding to the external environment.

A2.27 Among other things, this means that small countries tend to have better developed sensing mechanisms in terms of what is happening in the rest of the world. They see themselves as 'price takers', having to respond to external developments rather than believing that they can shape them. And the humility that comes with this perspective means they are more likely to be able to change course when necessary to adapt to a changing global landscape. As one piece of evidence in this regard, the IMD Competitiveness Yearbook reports data showing that small countries have more positive attitudes towards globalisation than large countries, being more open to the global economy.

A2.28 Overall, small countries have effective, responsive governments, with a well-developed sense of strategic capacity, high levels of trust and social cohesion, and the ability to adapt in response to changing international circumstances.

Policy Choices

A2.29 But these relatively exogenous factors – the state of the international environment and domestic intrinsics – are incomplete as an explanation of strong small economy performance. Even with good intrinsics, and a supportive external environment, a substantial amount of the variation in performance is due to the way in which countries act to position themselves. Successful small advanced economies are those that have adapted themselves to the global environment, developing positions of strong competitive advantage.

A2.30 Successful small advanced economies share several distinctive policy characteristics. These include high quality (macro and micro) policy foundations; a strong commitment to sustained investment in innovation, knowledge, and human capital; and an external orientation that drives strong international engagement.

A2.31 On all of these measures, small economies systematically out-perform larger economies. There is also a strong sense of strategic purpose, with a view on how to distinctively position the economy to compete. On many of these measures, there are significant differences between small economies and large economies (including the UK).

A2.32 Overall, post-crisis the environment is more challenging for small (and large) economies than has been enjoyed for much of the pre-crisis decades. However, small economies retain good intrinsics and have a history of responding effectively to change in the global economy. Many small advanced economies are responding aggressively and creatively to this new environment and are generating reasonable outcomes. Small advanced economies can continue to perform strongly if they act appropriately, although there is less room for error. As a result there tends to be fewer sustained policy errors than in larger economies.

Small Economy Policy in the Post-Crisis Environment

A2.33 There is a widely-shared sense across small advanced economies that this 'new normal' will require a new set of policy approaches to generate strong economic and social outcomes. Small economies will need to work harder to generate the rates of GDP growth they enjoyed before the crisis.

A2.34 Small economies have a track-record of policy innovation and have responded well to previous challenges. And over the past few years there has been a determined policy response to the new challenges and opportunities of structural change in the global economy. There have been three types of policy responses: strengthening policy foundations; investing in new growth engines; and economic risk and resilience.

A2.35 These responses are apparent in action taken in Scotland, albeit within the policy limitations of devolved powers. However, rather than review existing Scottish Government economic policy initiatives, this section draws on examples and lessons from elsewhere that might be instructive in learning lessons. This will be particularly important in the event of Scotland becoming independent, since the full range of policy approaches will then be available to pursue Scottish economic strategic interests, in a coherent and deliberative way, as has been apparent in the small advanced economy benchmark countries.

Strengthening Policy Foundations

A2.36 Most small advanced economies have well-regarded policy foundations. However, the challenges of the post-crisis environment have led to a renewed focus on improving the quality of these policy settings. There is an acute awareness of the need to strengthen productivity and improve cost competitiveness.

Investments in New Growth Engines

A2.37 In most successful small advanced economies, growth and innovation have been driven out of well-established clusters of economic activity. Over time, these clusters (and the firms within these clusters) have innovated, developed new positions of advantage in adjacent spaces, and so on. These clusters have been successful growth engines for small advanced economies. The export structures of many small advanced economies tend to be dominated by relatively small numbers of clusters that have built strong competitive positions in international markets.

A2.38 Small competitively-strong economies are continuing to invest in key sectors and clusters, to help them develop positions of advantage in a more competitive and challenging global economy. For example, several small countries, notably Denmark and the Netherlands, are actively taking advantage of the opportunities from the 4th Industrial Revolution (such as Denmark's Production Panel and the Smart Industry initiative in the Netherlands). This is a way of strengthening the international competitiveness of high-cost industrial sectors of the economy.

A2.39 This is supported by Research and Development (R&D) spending and human capital initiatives to ensure that the capabilities and strengths of small advanced economies remain at the forefront. Skills strategies are being upgraded in many small countries with more emphasis on vocational education and the matching of skills demand and supply - for example, the initiatives associated with the Action Plan for Jobs in Ireland.

A2.40 One other area of policy focus is on strengthening the pipeline of new high-growth firms. In many small economies, large firms have played an important role – and many of these firms remain highly productive and innovative, and are internationally successful (from Vestas to Nestle and Unilever to Novartis and ABB). But there is less evidence of younger firms that have grown aggressively: start-up rates are frequently respectable in small countries, but the process of scaling up has been more challenging. This is widely seen to be constraining productivity and employment growth as well as innovation.

A2.41 In response, there has been substantial firm-level policy activity in many small advanced economies. Some of this is focused on generating a stronger eco-system for innovative start-ups (such as Start-Up Delta in the Netherlands, the development of incubators in Switzerland, and so on). There are also many efforts in enterprise agencies to better focus their efforts on activities that support high-growth potential firms to expand aggressively into international markets (Ireland and New Zealand are good examples). Enterprise policy is becoming a much more central element of economic policy.

A2.42 Some of these attempts to encourage innovation are occurring in non-traditional sectors, especially in the digital space. Small countries such as the Netherlands, Sweden, and Ireland are particularly active in this area. Some of these new IT-intensive sectors are seen to play to small country strengths: high quality human capital, research institutions, good quality of life, and not as scale-sensitive as other sectors. Indeed, small economies in

Europe have produced several prominent start-ups (from Spotify to Rovio; and Skyscanner in Scotland) and there are several unicorns (in the fintech, payments space). Supporting policy initiatives include strengthening digital infrastructure (New Zealand), a responsive regulatory environment (Switzerland), as well as actions to strengthen capital markets.

Economic Risk and Resilience

A2.43 Economic risk and resilience has moved up the policy agenda in the post-crisis environment. There is an understanding of the exposures to a more uncertain, volatile global economic and political environment. Post-Nokia, there is a sharper realisation that key sectors in small economies are also exposed to disruptive changes in technologies, business models, consumer preferences, and so on, in ways that can have a material economic impact.

A2.44 Governments are building resilience into their macro and financial systems. Small country governments are also leading on financial stability measures, including introducing macro-prudential policy to limit the risks of housing bubbles and excessive levels of household debt (Singapore, New Zealand, and others).

A2.45 There is increased interest in market diversification to reduce the exposure to country or region-specific shocks. In Europe, countries such as Denmark, Finland and Ireland, have been developing strategies for developing relationships with emerging markets (particularly in Asia) as a hedge against the currently high levels of exposure to Europe (70% of Danish exports, for example, are currently sold to European markets). And in Asia, countries such as Singapore and New Zealand – which have benefited significantly from the rise of China – are now actively rebalancing portfolios to avoid the economic and political risks that come from over-exposure. In this context, an obvious danger of Brexit is that Scotland becomes ever more exposed to a low growth UK market.

A2.46 There is also interest in developing well-diversified portfolios of strengths at sector-cluster level - these clusters are well-positioned to absorb shocks. The experiences of small economies, such as Norway, Finland and New Zealand, are instructive in terms of the issues and policy approaches that are useful in this regard (from building labour market flexibility to deliberately investing in a pipeline of new strengths). But there are also risks from over-diversification and investing in areas where there is not a position of distinctive strength or capability. The policy answer to this is deeply country-specific.

A3 CHOOSING THE GROWTH MODEL FOR SCOTLAND

- The levels of international engagement by small advanced economies are substantially higher than for larger economies and the growth in international economic activity has also been stronger. This is the case for both exporting as well as cross-border direct investment.
- Large multinational firms play an important role in small advanced economies in driving international expansion.
- However, increasingly, small advanced economies are investing in firm-level enterprise policy to support international expansion by indigenous firms. Export promotion agencies are increasingly working intensively with high-growth potential firms to accelerate their international engagement.
- Small advanced economies take micro and macro policy foundations very seriously. In terms of micro or structural policy, small advanced economies rank highly on the various indexes of the quality of policy and flexibility of business environment.
- The strong performance of small countries is largely a matter of deliberate choice and management. It is the small advanced economies that have positioned themselves most appropriately for the challenges and opportunities of globalisation that have performed best. In contrast, those countries that did not engage with, and respond to, these global forces did not fare well.
- Two fundamental lessons are clear: Scotland must become more engaged, not less, in the global and European economy in order to boost growth. And the opportunity to contribute to, and benefit from, that growth must be more widely shared.
- The UK economic model: In considering the future, the UK economic model is wrong for Scotland. Leaving the EU and the Single Market, hostility to immigration, concentrating economic activity in London and the South-East of England, low wages and tolerating a large gap between rich and poor can only depress growth and opportunity.
- Our recommended starting point for a Next Generation Economic Model for Scotland is based on learning the lessons from small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. Drawing on all 12 small advanced economy case studies we are especially drawn to a hybrid of Denmark, Finland and New Zealand. Features of that model include: quality of governance; long term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location, placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective.

A3.1 There is no single small economy policy template that applies when picking the best international model for any one country. Various successful small advanced economies have very different policy settings: the Nordics are different from Ireland and New Zealand. Because context matters, it is not always helpful to talk about specific 'best practice' types of policy. But there are some general themes that are observed consistently across high-performing small advanced economies. These general policy themes are particularly instructive for informing Scotland's economic policy debate.

A3.2 The shared context of high-performing small advanced economies – operating at the income frontier, and highly open to the global economy – leads to similarities across the small advanced economy group in terms of the strategic design of economic policy. Specifically, global exposure means that small countries have to face a stronger competitive discipline with an accompanying sense that they need to be distinctive so they can compete with other larger economies but not take fiscal or dependency risks.

A3.3 Whereas larger advanced economies can rely more heavily on the domestic market, small advanced economies frequently develop a deliberate policy strategy to position themselves in the global economy to serve a more diversified customer base. The exact nature of this strategy will vary according to the specifics of the local context and comparative advantages/ relative costs. Examples include FDI attraction (Ireland), R&D and innovation-led strategies (Finland, Switzerland, Denmark), and the exploitation of natural resource-based comparative advantage (New Zealand, Norway).

A3.4 The nature of these strategies also needs to be sensitive to the external environment. For example, in the mid-late 1990s there was a concerted effort in many small economies to upgrade their innovation capability and investment to respond to new opportunities in the global economy. And from New Zealand to Denmark, there is currently intense economic policy across the small advanced economies group as these economies upgrade economic policy settings to respond to the post-crisis environment.

A3.5 This international experience provides a basis for informing the design of a growth agenda for Scotland that fits with its strategic context. Scotland has a good policy foundation in many respects, but deliberate policy choices will be required to secure the desired growth outcomes.

A3.6 Shifting towards policy settings and approaches that are typical of successful small economies would generate economic benefit for Scotland. There are several common policy themes and properties of high-performing small advanced economies from which Scotland can learn:

- active international engagement;
- strong, sustained investment in knowledge, innovation and human capital;

- strong policy foundations that provide the support for economic success specifically in the Scottish context;
- 'strategic coherence' – a clear view on how to position the economy to compete that allows specific policies to be aligned and integrated (which there would be considerably more scope for in an independent Scotland with a much wider range of powers available than are currently devolved).

A3.7 Whilst active international engagement and investment in knowledge, innovation and human capital are already priorities in Scottish economic policy, the lessons to be learned from the benchmark small advanced economies relate to strategic coherence, with all areas of policy, directed towards realising identified economic opportunities. In the Scottish context these include areas of policy currently reserved at Westminster as well as devolved areas.

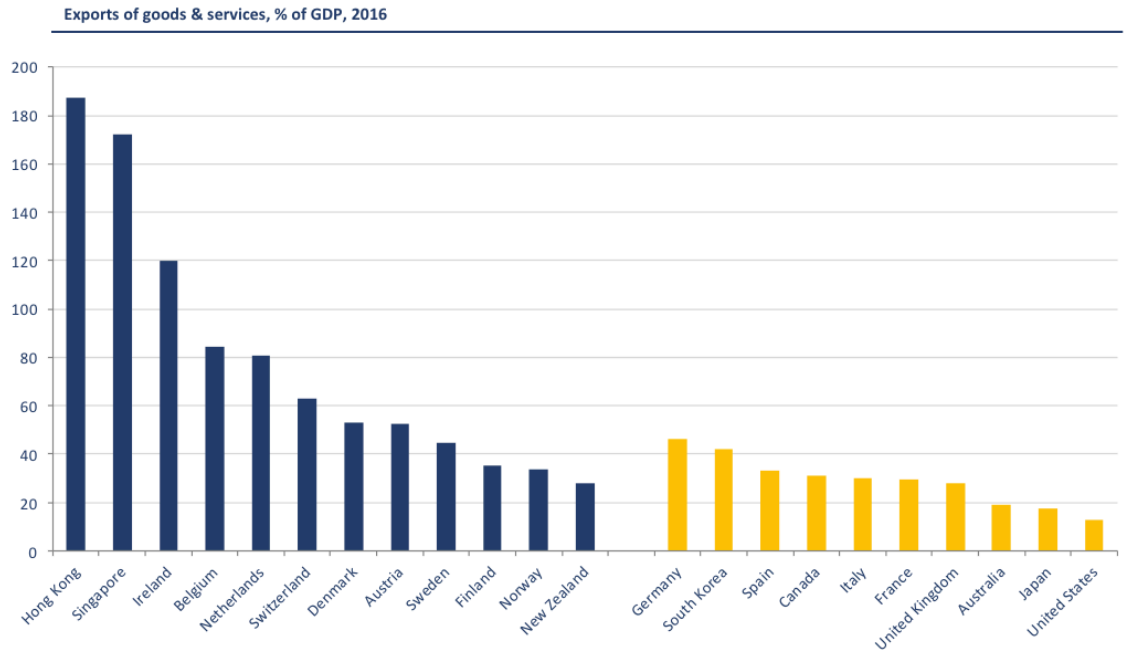
Active International Engagement

A3.8 Small economies have to develop a well-performing external sector in order to generate strong economic outcomes – the domestic market in small advanced economies is too small to get the required levels of scale and specialisation. Indeed, there are substantial differences in productivity levels between domestic and externally oriented sectors; this is true across advanced economies, but is particularly true for small advanced economies, and in Scotland, with a limited domestic market. International engagement is at the core of small country economic policy; this is a target outcome as well as central to the strategic policy approach.

A3.9 Figure 3-1, Figure 3-2, Figure 3-3, Figure 3-4 and Figure 3-5 report several measures of international economic engagement. The levels of international engagement by small advanced economies are substantially higher than for larger economies and the growth in international economic activity has also been stronger. This is the case for both exporting as well as cross-border direct investment.

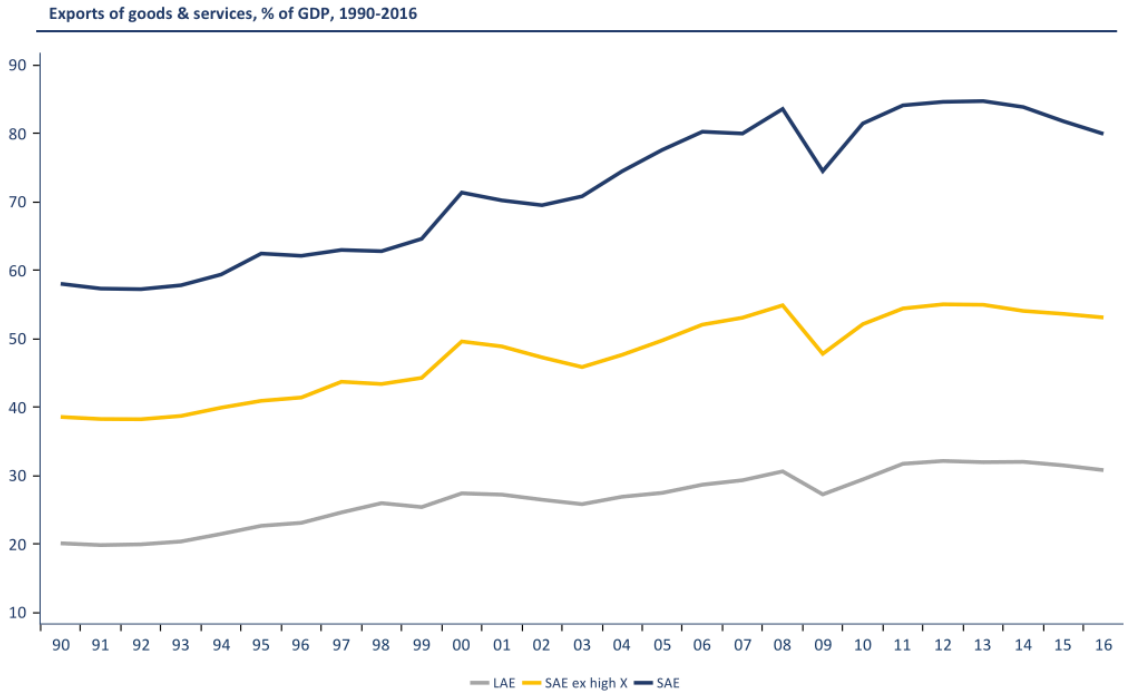
A3.10 The small economy group time series shows accelerating international intensity from the mid-1990s, partly reflecting strong global growth and the integration of emerging markets. Many small countries have also benefited substantially from inward direct investment, notably Ireland and Singapore which have placed FDI attraction at the centre of their respective economic strategies.

Figure 3-1 – Small advanced economies have significantly higher export shares than most larger advanced economies



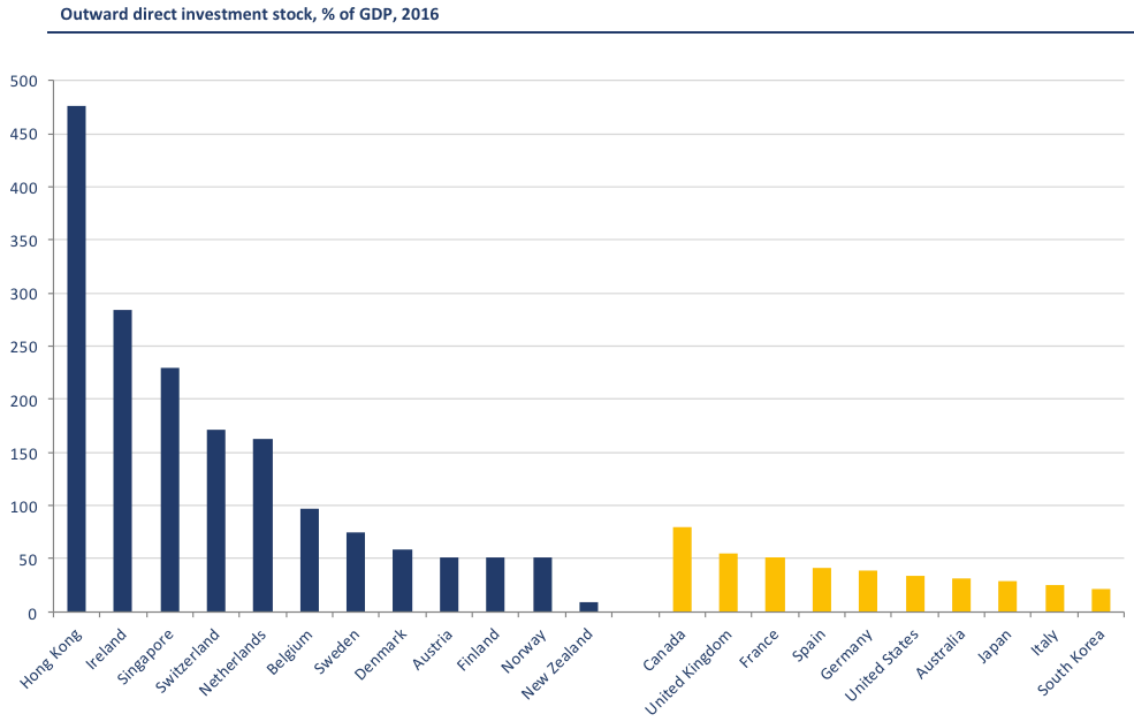
Source: World Bank, WDI, June 2017; Landfall Strategy Group calculations

Figure 3-2 – Small advanced economies grew their export shares strongly from the mid 1990s



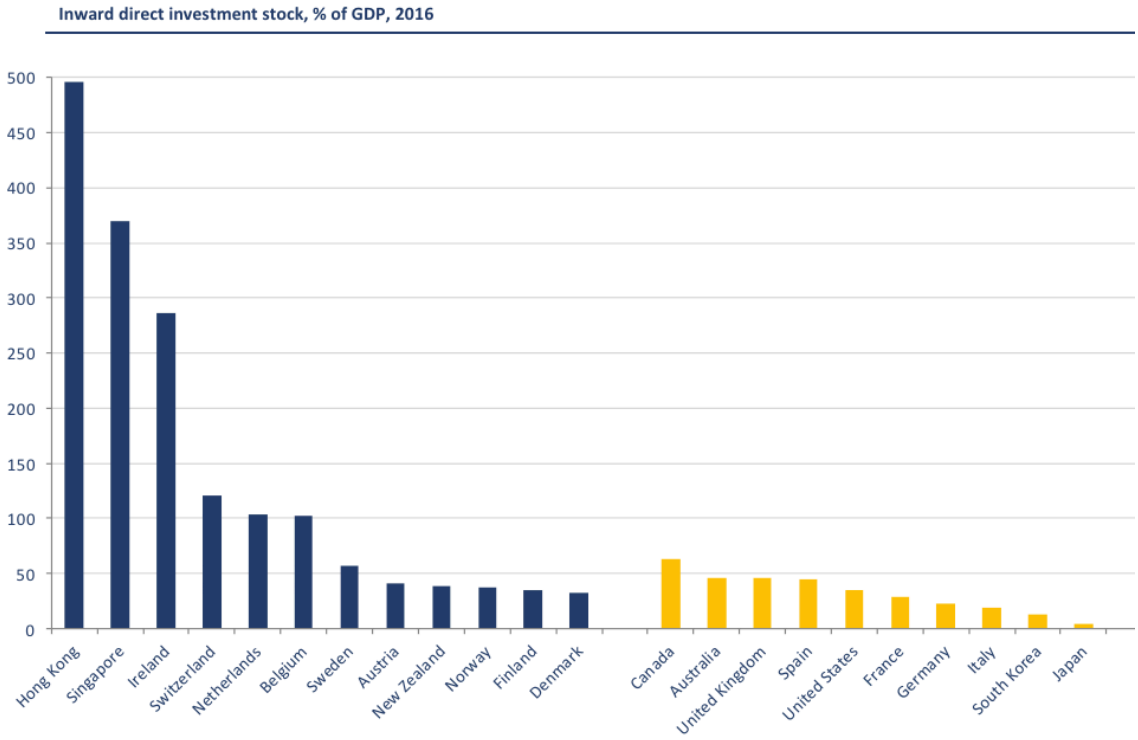
Source: World Bank, WDI, June 2017; Landfall Strategy Group calculations. Note: high export SAEs are Hong Kong, Ireland and Singapore.

Figure 3-3 – Small advanced economies also have very high levels of outward direct investment



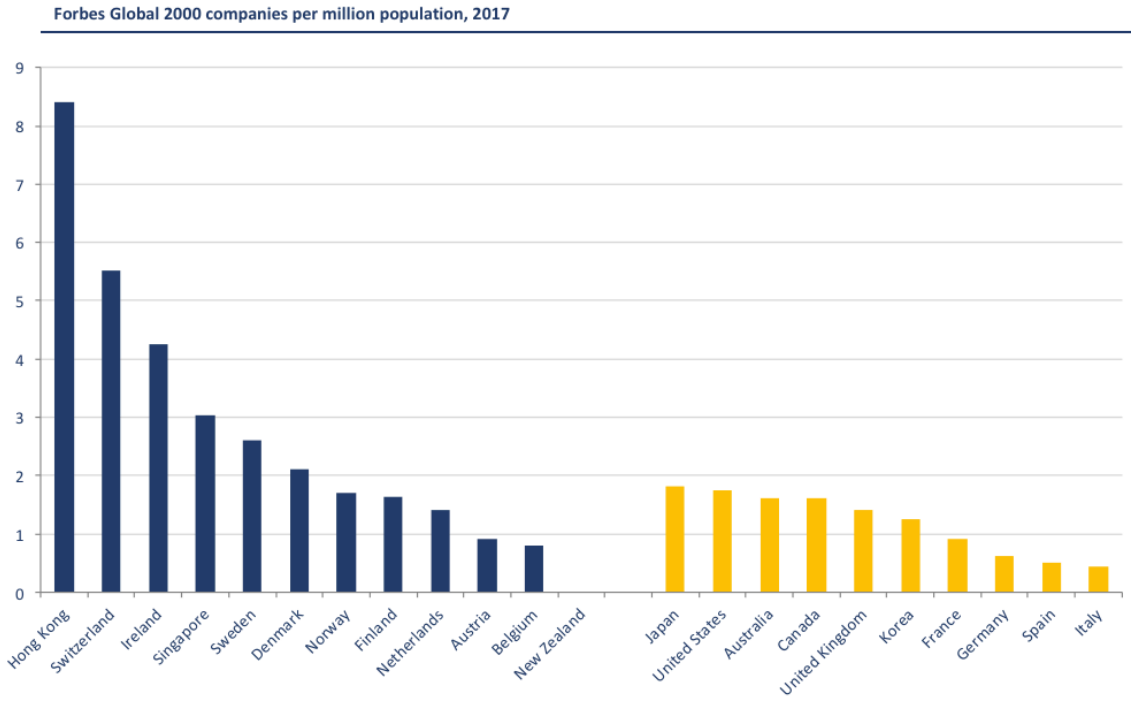
Source: UNCTAD

Figure 3-4 – Small advanced economies have high levels of inward direct investment; this is core to some small countries' economic strategies



Source: UNCTAD

Figure 3-5 – Small advanced economies produce a significant number of large multinationals



Source: Forbes Magazine Global 2000, 2017; IMF World Economic Outlook 2017; Landfall Strategy Group

A3.11 Large multinational firms play an important role in small advanced economies in driving international expansion (as well as contributing significantly to productivity and innovation). Figure 3-5 reports that small advanced economies produce more large companies per million of population than do their larger economy counterparts. The international activity of these small country firms is a central part of strong external engagement by small advanced economies.

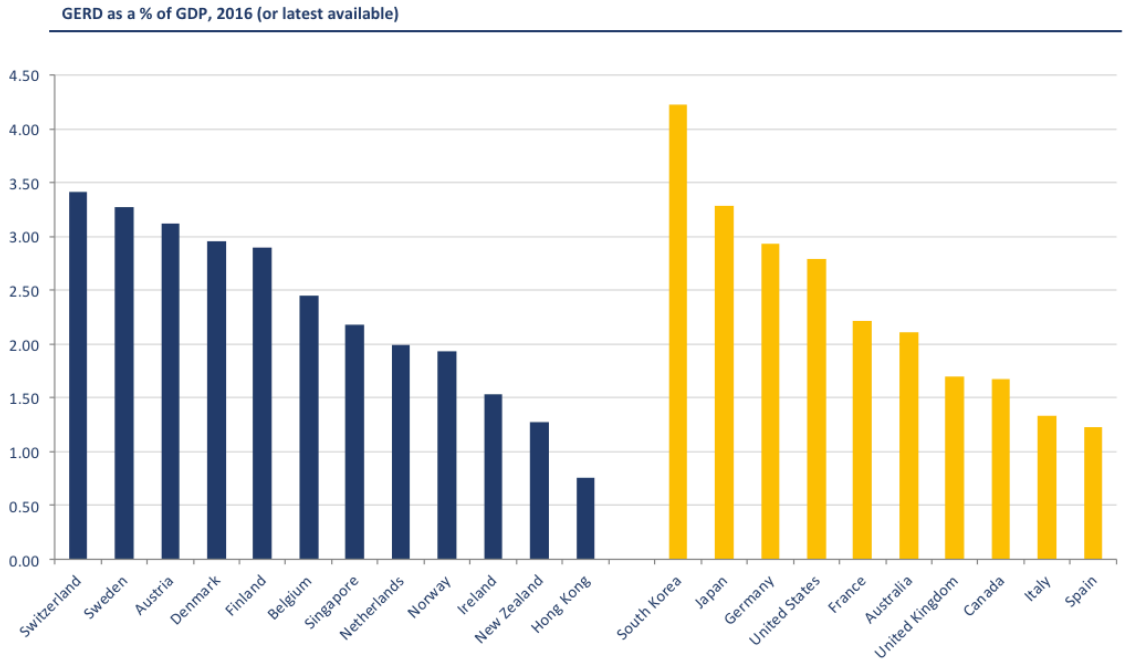
A3.12 Policy has also made an important contribution to international engagement by small advanced economies. The development of sound policy foundations, as well as investing heavily in innovation and human capital (discussed below), have made a substantial contribution to the competitive position of internationally engaged small economy firms.

Investing in Innovation and Human Capital

A3.13 Successful small advanced economies are characterised by heavy investments in knowledge, innovation and human capital (skills, retraining). It is commonly observed that small economies, because they have limited resources, act to ensure that they make the most of their people. This focus on knowledge and human capital has been central to the way in which small advanced economies have built distinctive international competitive positions. This capability is necessary to generate the high levels of labour productivity that underpins the competitive positioning of high cost small advanced economies in the global economy.

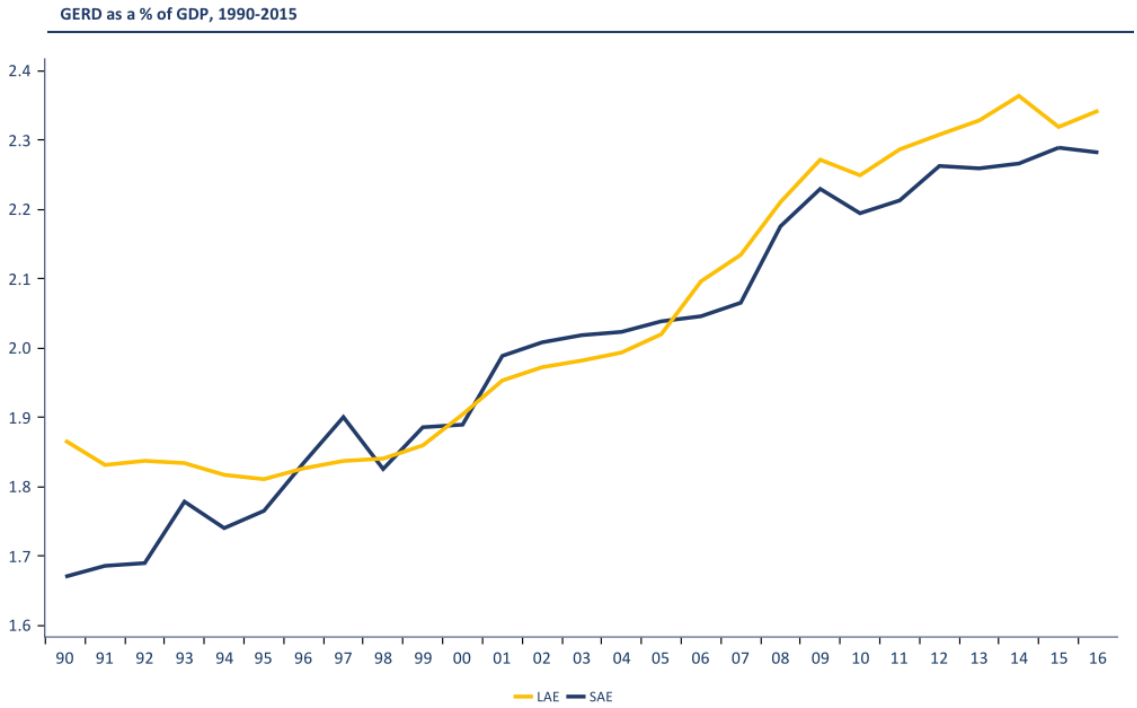
A3.14 Many small advanced economies invest very heavily in R&D (Figure 3-6). There is variation across the group (New Zealand is towards the bottom), and in the way in which innovation is undertaken (some like Ireland and Singapore rely on R&D intensive multi-national companies). The time series of R&D spending suggests an increased investment in R&D from the mid-late 1990s (Figure 3-7), which enabled small economies to transform the export structure (moving into higher value, higher growth categories).

Figure 3-6 – Several small advanced economies have sustained high levels of investment in R&D



Source: OECD, World Bank

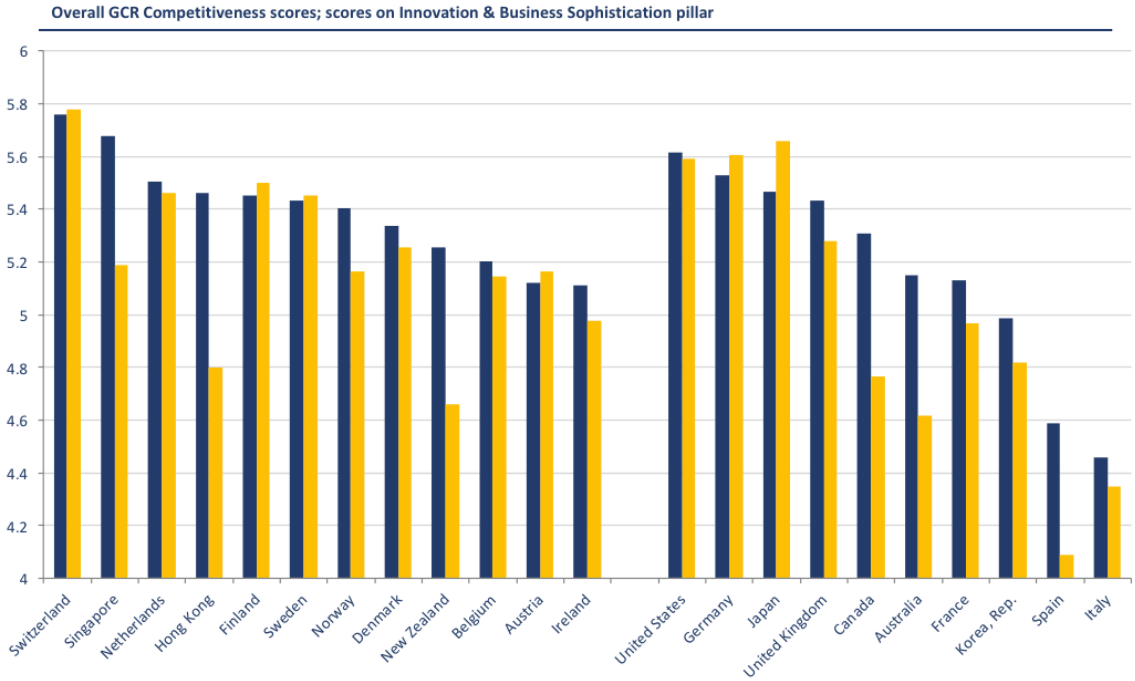
Figure 3-7 – R&D spending in small advanced economies accelerated from the mid 1990s



Source: OECD, World Bank; Landfall Strategy Group calculations

A3.15 One other measure of the domestic innovative capacity of small advanced economies is provided in the World Economic Forum's Global Competitiveness Report (Figure 3-8). Small advanced economies tend to perform well in the overall competitiveness rankings. But for advanced economies it is the performance on the innovation and business sophistication measures that are particularly relevant. Many of the high performing small economies, such as Switzerland and several Nordics, perform particularly well on this innovation measure. In contrast, countries such as Singapore and New Zealand perform less well.

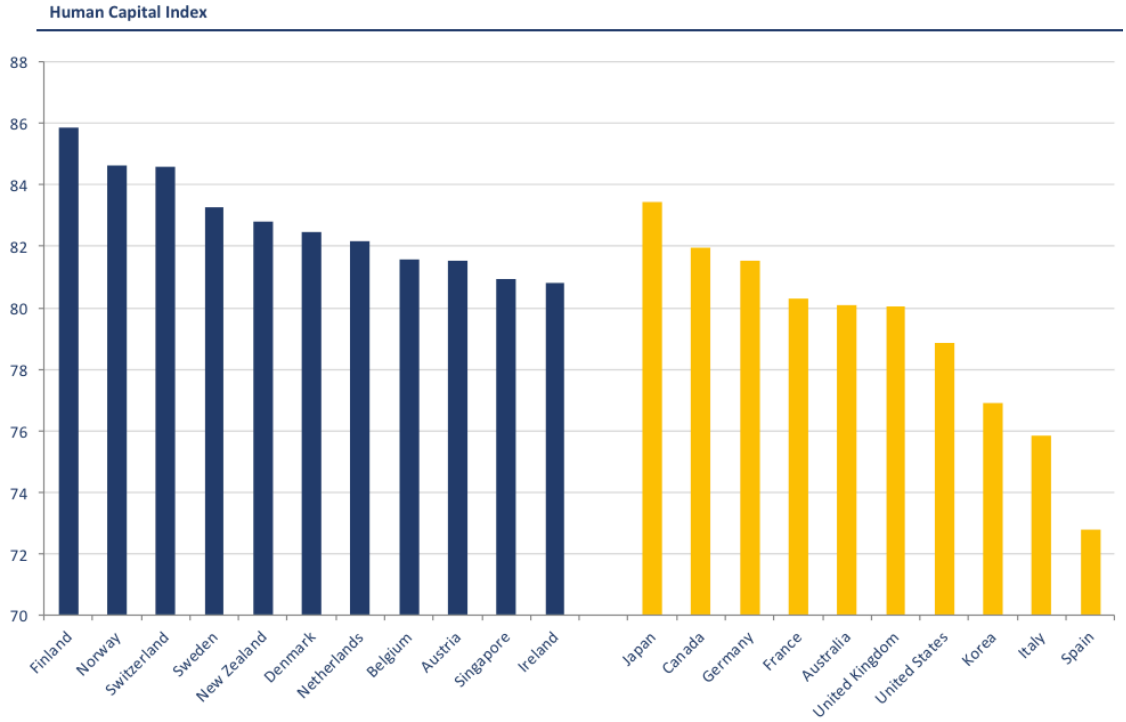
Figure 3-8 – Many small economies score well on innovation, as well as on overall measures of competitiveness



Source: 2016/17 Global Competitiveness Report, World Economic Forum (innovation=blue, business sophistication=yellow)

A3.16 In addition to these substantial investments in innovation, small countries also prioritise investment in human capital. Consider the strong performance of small advanced economies on the World Economic Forum's Human Capital Index, a composite measure of multiple dimensions of human capital (Figure 3-9). This performance is due to a combination of strong formal education systems, based on technical/vocational training and high quality schools, universities, and research institutions.

Figure 3-9 – Many small advanced economies score highly on measures of human capital, particularly in Northern Europe



Source: 2016 Human Capital Report, World Economic Forum

A3.17 Many small economies are currently investing in initiatives to prepare their existing and future workforce for the workplace of the future, recognising that disruptive change is on the way. A good example is the various initiatives associated with the Production Panel work in Denmark on capturing opportunities from emerging technological opportunities.

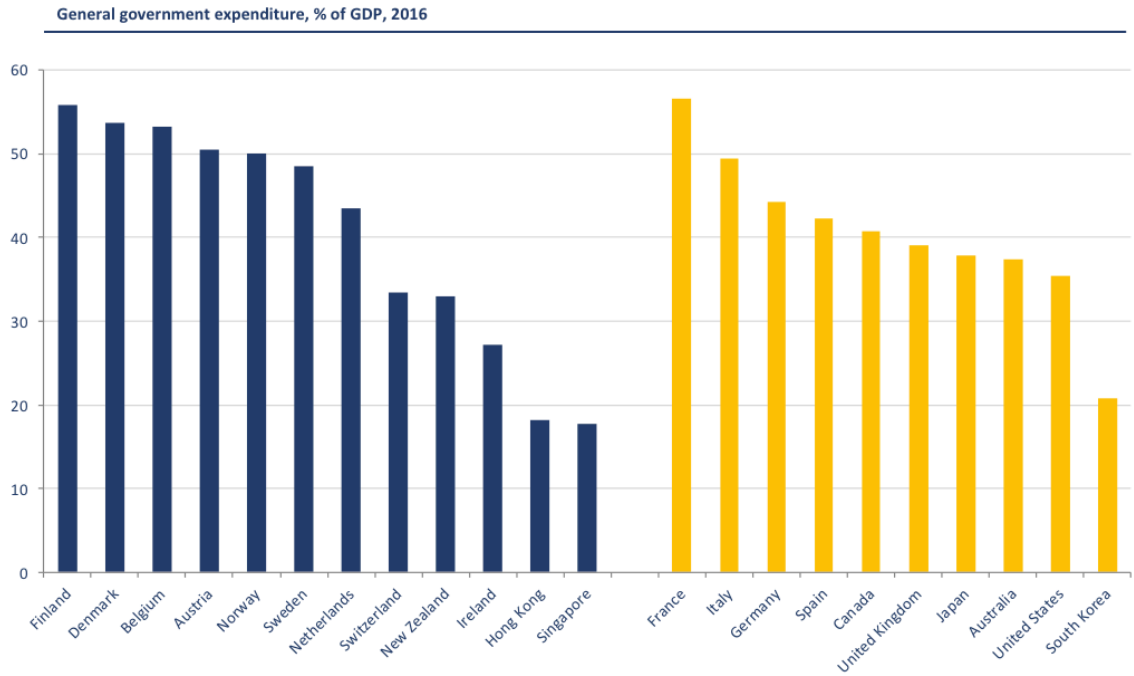
Strong Policy Foundations

A3.18 Small advanced economies take micro and macro policy foundations very seriously. In terms of micro or structural policy, small advanced economies rank highly on the various indexes of policy quality and the business environment. As just a few examples, small advanced economies have consistently dominated several international measures of competitiveness (including the World Economic Forum's Global Competitiveness Report noted above); the World Bank's 'ease of doing business' index, the various OECD measures of regulatory quality, World Bank measures of governance and so on.

A3.19 Small economies understand the importance of efficiency and flexibility, so that they are able to respond quickly to shocks and structural changes. This is an important part of both the economic dynamism of small economies as well as of economic resilience. One interesting dimension of this approach to flexibility is in terms of active retraining participation and a well-developed system of social insurance that allocates risks efficiently and supports the rapid movement of labour across an economy. Denmark and the Nordics are a good example of this approach, as is Switzerland.

A3.20 There is no such congruence in the approach to government spending in small advanced economies. Many successful small advanced economies (particularly in Europe) have high levels of government spending and tax (Figure 3-10), although others (New Zealand, Ireland, Singapore and Hong Kong) have lower levels of government spending. However, this spending needs to be supported by higher levels of productivity. Indeed, there is (slight) downward pressure on government tax and spending levels in small economies due to concern about slowing growth and cost competitiveness. This is currently an area of policy focus in countries such as Denmark and Finland. In the 15 years prior to the crisis, government spending and revenue in small advanced economies had been consistently trending down.

Figure 3-10 – Several successful advanced economies have high levels of government spending, although there is wide distribution



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

A3.21 On monetary policy, most small advanced economies do not have an independent policy. Many are part of the Eurozone or have chosen to peg/fix against another currency (such as Denmark and Hong Kong). The view of many small countries is that the relative stability and credibility of these arrangements beats the benefits of flexibility and that actual power and flexibility is heavily constrained in any event.

A3.22 Of those countries that do run their own monetary policy (Switzerland, Singapore, New Zealand, Norway and Sweden), there is recognition that although a national exchange rate can provide a buffer against shocks (which has recently benefited Norway, for example), small economies are deeply exposed to external events and there are therefore limits to the extent of genuine monetary policy independence available. As a result, small country central banks have from time to time been challenged by over-valued exchange rates, low

(or negative) interest rates, and booming property prices. But none have succumbed to a crisis.

A3.23 We return to this issue in part C of this report, on monetary policy and financial regulation.

Strategic Coherence

A3.24 The discussion above notes the common themes in high-performing small advanced economies. However, there is no single policy agenda, and small countries choose to compete in a variety of ways. For example, Sweden successfully follows a high tax, high wage, innovation-based model, whereas Hong Kong pursues a low tax, light regulation model with an emphasis on world-class infrastructure and leveraging its proximity to China. These models are very different, but both have generated consistently strong economic outcomes.

A3.25 So, small country performance is less about the policy specifics and more about the way in which these policies are packaged for the specific context – that is, it is about the strategic coherence of policies. Although the specific ways in which small countries compete vary according to context, the notion of deliberate strategies to position themselves is a common theme. In many small countries, there will be a clear sense of the national value proposition and the basis on which they compete in the global economy.

A3.26 Small countries have created a more positive, supportive external environment over the past few decades. But at least as important, they have responded appropriately to the changing global environment. The strong performance of small countries is largely a matter of deliberate choice and management. It is those small advanced economies that have positioned themselves most appropriately for the challenges and opportunities of globalisation over this period that have prospered. In contrast, those countries that did not engage with, and respond to, these global forces did not fare well.

A3.27 One dimension of this positioning is a deliberate development of key strengths in the economy that provide distinctive competitive advantages. These can be 'horizontal' factors, such as tax, physical location, human capital, business environment, or infrastructure. Or it could be more 'vertical' in nature, organised around key sectors or clusters. Most successful small advanced economies will have a limited number of deep clusters. These clusters of economic activity often provide the focus for a coordinated approach to policy and are made most effective when headquarters functions are present in the economy.

Implications for Scotland

A3.28 This discussion draws on the small advanced economy policy experience to provide a perspective on how Scotland might implement a small economy policy approach to generate stronger economic outcomes.

A3.29 Scotland is a modern, developed economy with generally high quality policy settings. The challenge for Scotland is that many of these policies are set for a large economy (the UK), not a small economy like Scotland, and are not directly aimed at strengthening the competitiveness of the Scottish economy in a way that reflects the Scottish context and needs.

A3.30 The experiences of high-performing small economies help to illustrate the types of strategic policy choices that Scotland could consider and how it could develop a distinctive competitive position in a challenging, competitive global economy.

A3.31 These policy insights can be organised around the three broad themes: (i) strengthening policy foundations; (ii) building competitive advantage, often organised around sectors or clusters of economic activity; and (iii) upgrading policy approaches to economic risk and resilience.

Strengthening Policy Foundations

i) Macroeconomic Policy

A3.32 Small advanced economies have made fiscal prudence a strategic priority. From Ireland to Denmark, Finland and New Zealand, small advanced economies continue to make concerted efforts to restore fiscal sustainability. This is a clear priority for Scotland. We present a credible plan for fiscal policy, with supporting fiscal institutions as a central element of a growth strategy for Scotland in part B. Without credible fiscal policy and financial sustainability in the public and private sectors, no economic strategy is likely to deliver on its goals.

A3.33 Small advanced economies also provide lessons for monetary policy arrangements in Scotland. We return to this in part C.

A3.34 While in general, macro policy is best seen as an important enabling factor, for Scotland this is a strategic imperative – both substantively and for credibility.

ii) Productivity

A3.35 Strengthening productivity performance and cost competitiveness is a common priority across small advanced economies – and should be for Scotland as well. The UK's level and growth of labour productivity has fallen below the EU average. Acting to raise productivity is a critical element of sustaining higher rates of GDP growth in Scotland, as in other small economies.

A3.36 In general, firms and sectors exposed to international markets converge to high levels of labour and capital productivity because they face greater competitive pressures to do so; if they do not become productive on a world scale they will likely go out of business. The priority then is to raise productivity in the domestic (or non-tradables) sectors, such as retail,

wholesale, construction and public services. These domestic sectors are large parts of the economy where much of the employment growth has been over the past few decades.

A3.37 Productivity in domestic sectors is a critical input to the competitive position of export sectors (and increasingly so, given slow growth externally), as well as contributing to inclusive growth through higher wages in these sectors (to reflect improved productivity).

A3.38 In Scotland, as in most other small advanced economies, improvements in productivity will come in myriad small advances, but a few major reforms are necessary to make that process feasible – most obviously in allowing dedicated policies to operate in the areas where productivity increases would bring the most benefit, to encourage capital (total factor) productivity or repair the current investment rate deficit. Much of this action is likely to be in quite detailed industry-specific areas. To identify the opportunities, many economies have established agencies such as a Productivity Commission or economic development bodies. These independent institutions are mandated to undertake research, gather data, identify opportunities for productivity improvement (particularly in domestic sectors), and make recommendations to government.

A3.39 Countries such as Denmark and Norway have established short-term commissions, staffed with independent experts, which have now reported to the government. In New Zealand, a permanent Productivity Commission was established in 2010 that undertakes a rolling series of reviews on specific sectors and issues (including extensive public and stakeholder engagement). These Commissions are seen to have been effective.

A3.40 Establishing a Productivity Commission in Scotland, along similar lines, to identify opportunities for productivity improvement would be useful. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a more permanent institution as in New Zealand, if appropriate.

iii) Growth Infrastructure

A3.41 Policy foundations extend to other elements of the overall business environment, such as the quality of human capital, physical and digital infrastructure, capital markets, market access, and so on. Scotland starts from a strong position on many dimensions. But on-going work will be required to ensure that Scotland remains competitive and productive on an international scale.

A3.42 Priorities include the nature of on-going market access from Scotland to the UK and the EU; ensuring that investments are made to adapt the workforce to changing demands; digital infrastructure; international connectivity and so on. How these are prioritised and sequenced should be informed by the specific areas in which Scotland wants to be distinctive.

A3.43 Countries such as New Zealand and Ireland have generated strong GDP growth rates by raising population. This may lead to limited improvements in per capita income or

productivity in the short-term, but would be a powerful source of growth for Scotland in the long term, as discussed later in this report.

Building Competitive Advantage ('Growth Engines')

A3.44 Strong, high quality policy foundations are a necessary but not sufficient condition for growth. It is not simply a matter of moving to policy 'best practice' but making a deliberate choice about how to use policies to position the economy.

A3.45 For example, some small counties have built successful growth models based on economy-wide strengths. Examples of this are Singapore, Hong Kong and Ireland, offering low tax rates, strong human capital and market access (to Asia and the EU respectively) and good infrastructure. Other economies have emphasised a growth model that builds on existing strengths and capabilities in key clusters – and where access to foreign capital is a supporting element (for example, the Nordics, Switzerland and the Netherlands).

A3.46 Ireland and Singapore have been remarkably successful economic growth stories, based largely around FDI attraction. Scotland also does well in attracting FDI (relative to other parts of the UK).

A3.47 Scotland is more likely to benefit from following a standard small economy growth model of building on existing strengths and capabilities which are far more substantial, at least on the face of it, than countries like Ireland began with on their growth policy journey.

A3.48 The instructive examples are countries such as Denmark, Finland, Sweden, the Netherlands and Switzerland. These successful small advanced economies have well-established clusters (with dense linkages) and successful, internationally-oriented firms.

A3.49 Another reason for deliberately building on existing strengths and capabilities is Scotland's economic geography. It is important to build strong clusters that are 'sticky' in Scotland, and that can attract and retain labour and capital against the gravitational pull of London and the South East. On the other hand, proximity to London may offer opportunities in making a more cost effective Scottish location more attractive.

A3.50 One near-term priority should be to identify the existing strengths and capabilities in the Scottish economy and assess how to support their growth, across all policy areas. These could include the energy sector (including renewables), food and drink, tourism, financial services, science and innovation, digital industries, biotech, education and so on, which are already the focus of economic development policy in Scotland.

A3.51 The decision on priorities should inform the strategic design of economic policy (for example, the emphasis and focus of R&D spending, infrastructure, human capital, the use of tax and spending priorities etc.). Policies in these areas should be designed to support the key areas of strength in the Scottish economy.

A3.52 In addition to existing strengths, it is also be appropriate to think about building new strengths: for example, in the digital economy. This is an area where many other small advanced economies are very active – on the basis that this plays to their strengths.

A3.53 Building growth is an area where there is major potential for Scotland to make improvements. The UK has a standard large economy approach to policy with little focus on industrial policy, and historically, Scotland has not had the full set of policy levers to do anything different.

Advanced Small Open Economies – Case Studies

Ireland

Key performance statistics[26]

- GDP per capita (2016): $62,562
- GDP growth rate (average since 2000): 4.6%
- Population growth (change since 1980): +37.1%
- Participation (jobs as % population, 2016): 43.5%
- Productivity (GDP per hour worked, PPP): $95.8

A3.54 Ireland has been one of the most rapidly growing developed economies over the past few decades on the back of a highly successful FDI-driven model (attracted by low corporate taxes, EU membership, and access to English-speaking human capital). Ireland was hit hard through the crisis as a consequence of the bursting of the property bubble and the subsequent bail out of the banks. But the basic structure of the economic model remains intact, and Ireland is recovering quickly with record amounts of FDI as well as an improving fiscal position. FDI into Ireland has made a major contribution to the domestic economy, although there are fewer examples of home grown strength. Greater effort is now being placed on supplementing the FDI-driven model with a focus on domestic strengths – through measures such as investing in research and innovation, skills, as well as enterprise policy. Ireland is also adapting to the prospect of a hard Brexit, and is diversifying its exposure to the UK economy.

A3.55 During the work of the Sustainable Growth Commission, its members have interacted with huge numbers of organisations and individuals, in Scotland and further afield, who offered to provide their perspective. This has provided an opportunity to gain a behind the scenes insight into what has driven stories of success elsewhere.

A3.56 One of those was the experience of Ireland as it recovered from the financial crisis. As well as necessary actions to deal with the financial crisis itself and then to secure macroeconomic stability, Ireland embarked on formulating a new economic strategy, planning for less reliance on inward investment and more on indigenous growth, as set out in its Action Plan

[26] Source: IMF World Economic Outlook and OECD.Stats Productivity

for Jobs. The insight that encouraged that development was that as a small country in a global economy, it would require only small global market shares in a few areas

A3.57 As one of those that provided their insight to the Commission said: "we realised that with a global outlook, we weren't really constrained by the size of the market because we couldn't possible produce all of product x that the world might need. So the challenges were different, they were about working out what we wanted to be good at and then investing so that we could build the skills and expertise to be good at it. We just needed to think about what Ireland could produce that the rest of the world might want."

A3.58 This lesson also applies to Scotland. As a country of just over 5 million people in a world of 7 billion, Scotland needs to be globally competitive in just a few niche areas to secure economic success. In this context, being globally competitive means achieving high productivity, in particular in sectors where the markets are global rather than local.

New Zealand

Key performance statistics[27]

- GDP per capita (2016): $38,345
- GDP growth rate (average since 2000): 4.6%
- Population growth (change since 1980): +51.8%
- Participation (jobs as % population, 2016): 52.0%
- Productivity (GDP per hour worked, PPP): $49.9

A3.59 New Zealand reformed its economy extensively in the 1980s and early 1990s, which placed it on a stronger footing. It has performed well over the past 20 years, including in the post-crisis period, with growth rates frequently above 3%. However, a significant portion of this growth has been due to growth in hours worked (low unemployment and high participation rates, favourable demographics, and very strong rates of net migration – markedly over the past few years). The economy is still based on exploiting natural resources, through agriculture and tourism, and its productivity performance is low. But this growth model has worked effectively, and uses options that are available to Scotland – notably migration. Investments in digital infrastructure and enterprise policy are also supporting a growing high growth firm community.

A3.60 Productivity theory and evidence, policy analysis, and the New Zealand context suggest that a number of factors are critical for improving New Zealand's productivity growth.

A3.61 The basis for robust productivity growth rests on a stable and certain macroeconomic platform and on the quality of New Zealand institutions. A stable macroeconomic environment, underpinned by well-designed fiscal and monetary policies, provides the base required for economic agents to make decisions, to invest, innovate and undertake

[27] Source: IMF World Economic Outlook and OECD.Stats Productivity

new ventures, with the certainty that their returns will not be undermined by a weaker future economy.

A3.62 Quality institutions, such as the structure of property rights and the existence of well-functioning markets, are a prerequisite. The quality of institutions is a central explanation of the differences in income and growth rates among countries. Institutions provide a basis for many of the drivers of productivity. For example, secure property rights are a prerequisite for investment in capital and innovation.

A3.63 Macroeconomic stability and sound institutional arrangements provide the core on which individuals and firms can plan and invest. Effective microeconomic policies are also necessary to create a business environment that rewards enterprise and innovation and provides the resources and flexibility for firms to identify economic opportunities and to move to take advantage of them.

A3.64 While many factors impact on productivity, evidence suggests that skills, innovation and investment are particularly important in determining productivity performance. In addition, given New Zealand's reliance on the primary sector, the sustainable management of natural resources is important in meeting both economic and environmental objectives. These factors do not impact on productivity in isolation, but are interrelated; advances in one area will alter the returns and incentives for activity under the other drivers of productivity. Ultimately, it is the entrepreneur who combines these factors of production, new ideas, skills and capital, in order to drive productivity growth.

A3.65 Human capital accumulation is important for productivity in its own right, and also has a key role in innovation and technological progress. Evidence is becoming increasing clear that a large proportion of the differences in GDP per capita growth between countries can be explained by differences in human capital achievement. Education and training have been emphasised as central to the accumulation of knowledge and ideas; higher skills foster greater levels of innovation and entrepreneurship and increase the ability of the economy to absorb, implement and adapt ideas generated by others. The appropriate skill mix in part depends on a sector's distance from the technology frontier, with a decision on whether to create innovation or to absorb and adapt knowledge from abroad. Skill formation is a cumulative process over the life course. The greatest returns come from improving the quality of education in the early years but this needs to be maintained by on-going quality in later years.

A3.66 Advances in knowledge, new products and processes and organisational technologies are central to long-run growth; this progress occurs through innovation and decisions made at the firm level about how capital and labour are combined to make output through the entrepreneurial process. Technological progress is, in part, determined by the level of investment in innovation, capital and skills. Innovation and knowledge spill overs, whereby the discovery or demonstration of a technology is adopted by a wider set of firms, are increasingly considered to be highly important for productivity growth. The rate of return

to society from R&D activities is typically in the order of 90 to 100 per cent, well above the private return of 20 to 30 per cent.

A3.67 Firm turnover drives productivity growth. New firms seek out and develop new profitable ventures: well-performing firms grow and increase their market share and poorer-performing firms exit the market, and their resources are reallocated to more productive uses. The OECD suggests that this turnover results in up to 50 per cent of a country's labour productivity growth. Creative destruction requires a business environment that supports enterprise and innovation. Entrepreneurs drive this creative destruction because of their role in demanding factor inputs, determining the balance between factors, and driving the efficiency with which they are combined.

A3.68 Regulatory and economic frameworks that encourage sustainable investment over time, and quick responses to emerging resource constraints and new opportunities to invest in natural resources are critical for productivity. As environmental considerations may constrain growth in some sectors, it will become increasingly important that the frameworks for managing environmental constraints are consistent with resources being applied in their most productive use. An increased scarcity of natural resources combined with rising concern for the natural environment also indicates that good management of natural resources will be critical for future economic success. However, it is important to note that sustainable natural resource management need not be at the cost of economic growth. Growing environmental pressures can be managed in such a way as to achieve both environmental and economic goals.

A3.69 From this consideration of the process of economic growth, five broad drivers of productivity emerge. These drivers provide a useful way to assess and develop policies to improve the productivity performance of New Zealand, and all are useful as a framework for increasing productivity in Scotland. In summary, they are:

- Enterprise – Entrepreneurs identify and realise new market opportunities, create investment opportunities and drive innovation.
- Innovation - Innovators generate, adopt and adapt new ideas and create investment and entrepreneurial opportunities.
- Skills – Skills enhance labour's contribution to growth, improve the economy's ability to innovate and adopt new ideas and increase investment opportunities.
- Investment – Investment improves and enlarges the capital stock, is an input in the entrepreneurial process and increases the returns to skill acquisition.
- Natural Resources – Sustainable resource management increases the opportunities and mitigates the risks associated with the increasing cost and declining availability of natural resources and with consumers' growing demand for environmentally sustainable products.

Finland

Key performance statistics[28]

- GDP per capita (2016): $43,169
- GDP growth rate (average since 2000): 2.4%
- Population growth (change since 1980): +15.0%
- Participation (jobs as % population, 2016): 44.6%
- Productivity (GDP per hour worked, PPP): $57.9

A3.70 After a deep recession in the early 1990s following the collapse of the Soviet Union, Finland's innovation-driven growth model has generated strong growth rates – frequently above 4% in the 15 years prior to the crisis. Finland has one of the highest R&D/GDP spending ratios in the world, which began to ramp up from the mid-1990s. And there was a strong policy focus on human capital, good macro policy, regional integration into Europe, and social cohesion. The shocks to hit Finland over the past several years have caused significant economic costs and will require significant structural reform to restore competitiveness. But Finland's strong fundamentals remain intact, and good progress is being made. Current areas of focus are creating an entrepreneurial economy, structural reform and fiscal consolidation, and strengthening international connectivity (including Asia).

Sweden

Key performance statistics[29]

- GDP per capita (2016): $51,165
- GDP growth rate (average since 2000): 2.4%
- Population growth (change since 1980): +20.2%
- Participation (jobs as % population, 2016): 49.1%
- Productivity (GDP per hour worked, PPP): $61.4

A3.71 Sweden has consistently out-performed Scotland over the past 15 years – and in a particularly pronounced way over the past few years, when it has been a stand-out performer in the small advanced economy group. Sweden has a strongly competitive export sector, with successful multinational firms, high levels of labour productivity, as well as good social outcomes. Growth rates have consistently been above 4% since 1995, and above 3% over the past few years. Strong export growth has been a key contributor to this recent growth – together with a strong start-up scene, with firms like Spotify.

[28] Source: IMF World Economic Outlook and OECD.Stats Productivity

[29] Source: IMF World Economic Outlook and OECD.Stats Productivity

Denmark

Key performance statistics[30]

- GDP per capita (2016): $53,744
- GDP growth rate (average since 2000): 2.4%
- Population growth (change since 1980): +11.4%
- Participation (jobs as % population, 2016): 49.8%
- Productivity (GDP per hour worked, PPP): $70.4

A3.72 Denmark has high levels of per capita income on the back of a productive economy – supported by successful multinational firms (Maersk, Vestas, Carlsberg and others) – as well as strong labour market outcomes.

A3.73 Indeed, one of Denmark's most notably policy characteristics is 'flexicurity', which combines highly flexible labour markets (an ability to hire and fire) with a well-developed social insurance scheme and active labour market policy, which provides support for people to find their next job. This scheme has contributed to a flexible economy, as well as an efficient allocation of risk within the economy.

A3.74 Denmark invests heavily in research and innovation: for example, renewable energy has received substantial support (and is now an important export sector), and Industry 4.0 is an area of substantial policy activity (seen as an opportunity to maintain Denmark's industrial base, by making manufacturing feasible in a high wage, high cost economy).

Model for Scotland: the Next Generation Growth Model

A3.75 These small country experiences show a range of policy approaches: each have been successful in their own way. But context is important for success. And the other feature of the successful small economy experience is the strategic coherence of the policies: they are internally consistent and supportive of the overall direction. The implication for Scotland is that an explicit choice needs to be made in terms of what sort of policy model is appropriate (and what this means in terms of policy choices).

A3.76 Broadly speaking, there are three small economy archetypes that can be distinguished:

- the Ireland/Singapore model: low tax, light touch regulation, with an economic model based on attracting FDI (and providing a platform to an adjacent large market)
- The Nordic model: higher tax, higher cost (wages), flexible labour and product markets, supported by very high productivity firms and workers

[30] Source: IMF World Economic Outlook and OECD.Stats Productivity

- the NZ model: moderate taxes, skilled population, resource endowment plus tourism, a little peripheral to markets

A3.77 For Scotland, although it has been successful at attracting FDI (and should work to continue to do so), it seems unlikely that it can successfully operate an Ireland/Singapore model – Ireland has strong first mover advantage, Scotland has a challenging fiscal situation that would make it difficult to deliver aggressive tax cuts, and it would involve a very substantial set of changes to the overall economic policy mix. Moreover the ability to continue to compete, for example on lower corporation tax, must be questioned as countries seek to co-operate to ensure that multi-nationals are paying appropriate levels of tax. That said, any county ought to be acutely aware of the competitiveness of its taxation mix alongside its policy offer especially with regard to neighbouring economies. There will be both opportunities and challenges to be navigated from this.

A3.78 The Nordic model is clearly attractive, but is challenging. It rests on a particular social model, a high and broadly-shared stock of human capital, and high levels of productivity. Substantial, longer term improvements to Scotland's productivity performance would be required to move towards such a model but the ambition must be to reach such a standard.

A3.79 New Zealand has generated reasonably strong rates of GDP growth – on the back of strong migration and labour market performance, as well as growth in agriculture and tourism. It has also significantly improved economic management, which has made its economy more resilient and flexible.

A3.80 The lesson here is that no one existing model can simply be replicated. A Scottish growth model which learns from other successful nations, builds on Scotland's strengths and understands our own circumstances will be successful.

A3.81 Taken together, this is a model that seems to fit the Scottish context – and is achievable given Scotland's current set of economic policies. A hybrid of the best of Denmark, Finland and New Zealand as a broad strategy with the best of other countries taken where relevant.

A3.82 So the proposed Scottish next generation growth model, applies the lessons from each of these models that best fits with Scottish circumstances, needs and opportunities. The key features of the recommended Scottish include:

- Innovation-focused: a focus on innovation to boost productivity, building on the globally competitive university sector (learning from the Nordic model, in particular Finland);
- Competitive location for international investment: an openness to foreign direct investment (like Ireland), but competing not on labour costs or tax incentives, but on access to markets and to the highly skilled workforce and university sector;

- **Exploiting Scotland's resource endowment**: recognition that there are opportunities for Scotland based on its resource endowment, in particular in energy, food and drink and in tourism;
- **Export-orientated**: based on further development of the Scottish brand proposition to the benefit of industries initially focused on Scotland's natural resources (like New Zealand), but also on innovative companies in growth sectors, emerging from the focus on innovation (like Denmark and Finland);
- **Migration-friendly**: Scotland's population structure means that it is imperative the working age population grows much more than is currently projected and that can be achieved by welcoming migrants (as all the benchmark economies have done, New Zealand and Ireland in particular);
- **Flexible labour markets combined with fair and progressive work and active employment polices**: fair labour markets combining flexibility with high standards can help to make Scotland a competitive location for indigenous and international investment and ensure that the growth sectors can attract the skilled workers they need. But (as Denmark has shown) if combined with a matching generous system of unemployment benefits and active employment policies so that those leaving jobs can quickly find other suitable opportunities, this does not need to lead to job insecurity;
- **Maintaining a highly skilled workforce with transferable skills:** flexible labour markets and a focus on innovation mean that significant investment in skills, for young people and those already well established in their careers is necessary so that the workforce is highly skilled and has skills that can be transferred between sectors (like in New Zealand and Demark);
- **Taxation as a tool for economic development**: the innovation and skills offer that Scotland can provide, together with the natural resource endowment, means that there is little sense in competing as a low cost or low tax location. However, the taxation system can be used to support the economic strategy (for example, to attract people and investment);
- **Inclusive growth at the heart of the strategy**: all of the features described above are supportive rather than conflicting with placing inclusive growth at the heart of Scotland's economic strategy (as has been the case in the Nordic model). This also means working in partnership with business and the trade unions to ensure a sustainable and supportive economic model;
- **Quality of life as an asset and objective:** under-lying all of the above must be a recognition that the objective of the model should not be economic growth for its own sake but that the purpose of the model is to provide a good quality of life for everyone who lives in Scotland.

A3.83 We recognise that there are tensions between some of these features. However, the case studies of benchmark small advanced economics have shown that such a mix is possible. This will require regular review and refinement to make sure that some features of the model don't begin to dominate others. All of this requires a collaborative approach to policy design and implementation, as discussed further below.

A3.84 We recognise though that such a model recommendation requires broad debate and that many politicians and policymakers and analysts will have a different view. That we would even have such a debate would be a significant advance on the content and conduct of our debate over recent decades. However, in the end, it would be to the very significant advantage of the country if broad agreement on strategic direction could be agreed. Given the relatively moderate nature of the main political parties, this must be possible, as we come on to discuss on population and migration below. For all the sound and fury of the Scottish debate, we believe we have a quality and moderation in our political culture that has the potential to deliver the leadership the country required.

Collaborative Approach to Meeting Growth Aspirations

A3.85 The central lesson to take from both the lessons from successful small advanced economies and from the engagement exercise is that a successful economic strategy needs to embrace all areas of public policy and so consist of hundreds of policy measures.

A3.86 Some of the key measures that will make a difference are set out in this report. However, we are living in a fast changing world and the opportunities and threats that exist in one, five or ten years' time will be different to those that exist now. Scotland therefore needs an institutional framework that allows government, business and others to work together collaboratively, at a strategic level, to identify the emerging opportunities, agree the actions necessary to realise them and move swiftly to implementation.

A3.87 One of the main lessons to take from the small advanced economies relates not to what they do in terms of economic strategy but to how they do it.

A3.88 They have a strategic coherence, a consensus on what the long term objectives should be, and structures in place to ensure that there is a broad collaborative effort to identify new opportunities and threats and to implement the strategy. That needs to involve government, business, trade unions and other social partners and wider civic society working together, in collaborative structures, for the common purpose of improving the welfare and quality of life of people living in Scotland.

A3.89 There can sometimes by mistrust between business and government and part of that can be a view in the business community that the electoral cycle will encourage governments to make spending commitments that appeal to voters in the short term rather than spending that generates long term growth (and therefore provides the taxation revenues required to fund spending and borrowing commitments).

A3.90 This relationship between government and business and trade unions and other social partners can be transformed by a collaborative approach to economic policy making, based on analysis of practice of what happens in small successful advanced economies such as Denmark. There are also examples of this approach in larger successful advanced economies, notably in Germany (where the collaboration is often at the sub-national or regional level) and at the city level, notably Chicago.

A3.91 There are existing structures in place in Scotland that allows the Scottish Government to consult and engage with business and others and the scale of Scotland means that it can be easier for businesses to approach government to highlight an opportunity or a problem that needs to be addressed.

A3.92 These structures have their place, but what we are proposing here is a more active collaboration, where government, business and others co-design the economic strategy and commit to implementing it together. It was apparent during the consultation programme undertaken by the Commission that many representative groups have a good understanding of the opportunities that existing in their sector and how they can contribute to the overall national economic strategy. There are some good examples of joint working already in Scotland, including some of the sector based groups that are co-chaired by government and business leaders.

A3.93 Capturing and implementing these ideas requires more than consultations and lobbying. It requires joint strategy and working groups, institutional arrangements such as that used by the Productivity Commission in Denmark, covering both overall strategy (covering all areas of public policy, not just economic development policy) and the development of action plans for implementation.

A3.94 A collaborative approach to policy making means that government, business and other representatives of society work together on the development of policies and integrated strategies designed to exploit competitive advantages. This approach is consistent with both Christian Democrat and Social Democrat traditions in European politics.

A3.95 Integration of policy can also lead to better outcomes that take a more holistic and longer-term view of the costs and benefits of policy change. For example, an energy policy that was informed by economic development objectives as well as costs, security of supply and environmental impact may prioritise the commercialisation and growth of new sectors with export potential.

A3.96 In addition to a more strategic decision making process and the integration of policy, a collaborative approach also reduces the chances of policy shocks that businesses had not been expecting.

A3.97 Both the process of developing a comprehensive strategy and the role of the strategy of providing an overarching framework for public policy will deliver a range of benefits. These will include:

- a framework that coherently sets out the needs, opportunities and preferences of Scotland;
- a long term perspective on priorities and strategic objectives, above and beyond the political cycle (at least in the many areas where there is a degree of consensus);
- a framework that provides the long term stability sought by investors who wish to understand and manage the risks associated with investing;
- a mechanism to prioritise scarce resources on the challenges and needs identified as strategic priorities. These include public sector resources as well as human, natural and technological resources;
- a mechanism for the integration of policy since the strategy will provide the framework within which more detailed policies and sector based strategies can be developed; and
- the process of developing and reviewing strategy encourages a regular review of the progress that is being made and benchmarking against and learning from the best.

A3.98 The collaborative approach means that business expertise is brought to bear in identifying the opportunities. It also means that the private sector is aware of and understands the rationale behind the long-term strategy, providing the confidence that is required to stimulate the significant private sector investment that will accelerate economic growth.

Key Recommendations

A3.99 **National Economic Strategy:** The creation of an overarching national economic strategy that (as far as is possible) focuses on long term goals and secures broad cross partisan and sectoral support should be the central goal of growth policy. This is and of itself a necessary but not sufficient factor for success. **Growth goals:** The Strategy should include globally ambitious growth goals, to i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.

A3.100 Our recommended starting point for a **Next Generation Economic Model for Scotland** is based on learning the lessons from small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. Drawing on all 12 small advanced economy case studies we are especially drawn to a hybrid of Denmark, Finland and New Zealand. Features of that model include: quality of governance; long term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location,

placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective.

A3.101 **Delivering Cross-Partisanship and Collaboration:** A cross-partisan collaborative approach to policymaking against the long-term national strategic framework should be institutionalised. Direct engagement across sectors, business representative, employee representative and other policy groups should be institutionalised to ensure that the national economic strategy remains a vital and dynamic part of policymaking.

A3.102 **Identifying comparative advantage and strategic priority sectors**: while we are leery of the idea of 'picking winners' a clear choice should be considered in identifying and promoting those areas (rather than particular firms) in which we judge the Scottish economy to have sustainable comparative advantage. The process of selecting strategic priorities should be a key output.

A3.103 **Productivity Commission**. We recommend the establishing of a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model if appropriate.

A4 THE IMPERATIVE OF POPULATION GROWTH

- Scotland has recently been transformed from a nation suffering from population decline to a country benefitting from net immigration for the first time in our recent history. Positioning ourselves with an outward focus will both increase opportunities for the next generation of Scots born here and ensure we continue to attract talent.
- Given the demographic structure of Scotland, migration is critically important to population growth and also productivity performance. IMF evidence suggests a 1 per cent increase in the share of migrants in the adult population can increase productivity by 3 per cent long term.
- Scotland must continue to attract people in order to increase our working population and our overall population. Migration will account for all of Scotland's population growth over the projection period 2016-2041. Maintaining immigration is essential otherwise the number of people working and paying taxes will fall. The economic activity and employment rates of those born outside of the UK are higher than those in the rest of the Scottish population.
- There are around 429,000 resident in Scotland people who were born outside of the UK, 8.1% of Scotland's total population. London has the highest share of its population born outside of the UK (38.3%).
- The contribution of non-UK born citizens to the Scottish economy is estimated at approximately £12 billion per year.
- The 429,000 Scottish residents who were born overseas are associated with £4.3 billion of government revenue, including income tax and national insurance contributions. Government spending associated with Scottish residents who were born overseas stood at £3.0 billion. This suggests a net contribution to Scotland's public purse of £1.3 billion per year. The Polish community alone is a net contributor of circa. £250 million.
- We estimate that approximately £1.1 billion in exports in 2015-16 was attributable to overseas students studying in Scotland. Each student from outwith the EU generated £26,811 in exports for the Scottish economy in 2015-16 and each student from within the EU generated £14,812. However, given that much of the spending of students is consumer spending in Scotland, like tourism exports these figures are not fully reflected in reported export statistics.
- Overseas students in Scotland also make a net positive contribution to the UK Exchequer of around £2,500.
- Policy should prioritise Scotland's rankings in the main world competitiveness league tables and related trade-offs considered and agreed for long term policy.
- The attraction of economic migrants (from identified target groups) should be one of the top priorities of Scottish Government economic policy. Policies are recommended to remove barriers provided in UK policy and to incentivise talent to come to Scotland.

- Tone and message matter every bit as much as policy specifics, the whole country must market itself as a welcoming home for new talent and overseas citizens already based here. We should seek to be the most talent friendly country in the world.

Population Growth and Benefits Of Migration

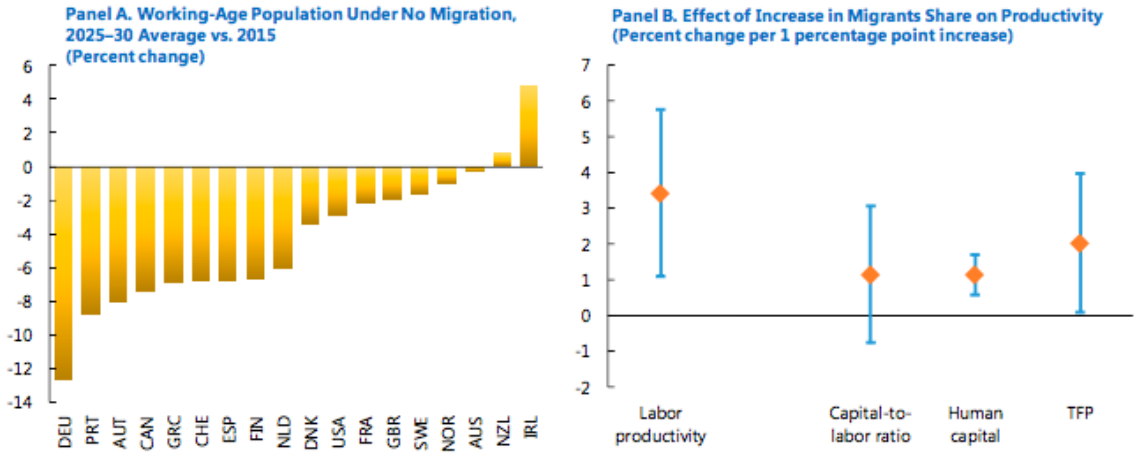
A4.1 During the twentieth century the growth in the population of Scotland slowed down and then the actually began to fall towards the end of the century. This was driven by falling birth-rates, in common with most advanced countries, exacerbated by emigration from Scotland as (usually) young people left in search of economic opportunities and the failure to attract sufficient immigrants.

A4.2 As discussed earlier in this report, population levels, alongside participation in the economy and productivity, is a key driver of economic growth. It would be a mistake to see population growth as a reflection of underlying growth solely as the growth can in and of itself create new demand and activity. After decades of static population levels in Scotland while other advanced economies have grown as both as a cause and consequence of good economic performance, in this century Scotland has become a country of net migration. With Brexit, the end of free movement within Europe and UK Government immigration targets, this could change, to the serious detriment of the Scottish economy (and Scotland's fiscal position).

A4.3 Population trends are also linked to productivity trends, which magnifies the economic effects. Recently published research on productivity trends by the IMF[31] notes than immigration plays an important role in population growth, accounting for about half of working-age population growth in most advanced economies between 1990 and 2010. Migrants tend to be younger and more economically active than the existing population. The research also shows that immigration has a sizeable effect on productivity, finding that a 1 percent increase in the share of migrants in the adult population increases labour productivity by up to 3 percent in the long term, through both higher human capital and improved total factor productivity. The mechanisms for that were highlighted in Chapter 6, but require investment in plant and innovation as well as skills.

[31] IMF (April 2017), Gone with the Headwinds: Global Productivity

Figure 4.1 – Projected Working-Age Population and Productivity Gains from Immigration



Sources: United Nations, World Population Prospects, 2015 Revision; Jaumotte, Koloskova, and Saxena (2016); and IMF staff calculations.
Note: Data labels in Panel A use International Organization for Standardization (ISO) country codes. Estimated effect of migration is based on a two-stage least squares approach, where the migration share is instrumented using a gravity-type model of bilateral migration flows. See further details in Appendix VII and Jaumotte, Koloskova, and Saxena (2015).

Source: IMF (April 2017), Gone with the Headwinds: Global Productivity

A4.4 This can be demonstrated by the positive contribution that those moving to Scotland from elsewhere are making to the Scottish economy.

A4.5 As discussed in the previous chapter, Scotland's population has grown since devolution, following decades of static or declining population.

A4.6 The structure of the Scottish population is also forecast to change, with a 28% increase in the number of pensioners forecast over the next 25 years, but only a 1% increase in the working age population[32].

A4.7 All advanced economies will face challenges associated with ageing populations (and so there are economic opportunities associated with products and services that help address these challenges). However, the distinctive challenge that Scotland faces is related not so much to the increase in the number of pensioners (the UK as a whole is forecast to see a 33% growth in the number of pensioners over the next 25 years) but from the limited growth forecast for the working population (the 1% for Scotland compares to an 11% increase forecast for the UK).

A4.8 This demonstrates the imperative to increase Scotland's population, in particular its working age population.

International Citizens

A4.9 This section sets out the contribution international migration has made to Scotland's economy and public finances. The contribution of migrants was measured using the latest

[32] National Records of Scotland (August 2017), Scotland's Population The Registrar General's Annual Review of Demographic Trends

available labour market data and an economic model made publicly available by the Scottish Government.

A4.10 The measures shown in this report does not fully reflect the wider social contributions made by Scottish residents who were born outside of the UK. Furthermore, these figures should be viewed as a snapshot of the contribution of migrants to Scotland. Once the UK leaves the European Union (EU), the dynamics of migration flows between Scotland and the rest of the world are likely to change significantly.

A4.11 This section of the report is based on analysis undertaken by 4-consulting and adopts a similar approach to that used in 4-consulting's report on EU migration which was submitted to the Scottish Parliament last year.

Those Born in Other Countries Living in Scotland

A4.12 It is difficult to measure the number of people living in Scotland who were born outside of the UK and their social and economic contribution. An ONS research paper outlined the differences in international migration estimates based on tax records and migration surveys (ONS, May 2016).

A4.13 This report uses data from the latest Labour Force Survey (LFS) to extend the Scottish Government's Input-Output tables and economic impact model to estimate the likely contribution made to Scotland's economy. As noted above, this measure does not reflect the wider social contributions made by Scottish residents who were born outside of the UK.

A4.14 The LFS includes questions on the country of birth of those living in Scotland. The latest data available from the Quarterly LFS is shown in Table 4-1 below covering the period January to March 2016. The figures taken from the LFS are based on a survey and are estimates.

A4.15 There are around 429,000 people who were born outside of the UK accounting for around 8.1% of Scotland's total population, shown in Table 4-1. London has the highest share of its population born outside of the UK (38.3%).

Table 4-1: Proportion of Residents Born in Other Countries (000s)

Country or Region	Born Outside of the UK			Total Resident Population	Population Share
	EU Countries	Rest of World	Total		
London	1,043	2,277	3,320	8,666	38.3%
South East	484	680	1,164	8,859	13.1%
West Midlands	234	482	716	5,712	12.5%
East of England	317	399	716	6,041	11.9%
East Midlands	241	264	505	4,629	10.9%
North West	312	385	697	7,097	9.8%
Yorkshire	199	306	505	5,335	9.5%
South West	204	242	446	5,406	8.3%
Scotland	**209**	**220**	**429**	**5,291**	**8.1%**
Northern Ireland	106	34	140	1,835	7.6%
North East	56	103	159	2,601	6.1%
Wales	100	80	180	3,071	5.9%
UK	3,505	5,473	8,978	64,544	13.9%

SOURCE: Quarterly Labour Force Survey (Jan-Mar 2016)

A4.16 The figures shown in Table 4-1 are similar to those published by the ONS earlier this year in the report Population of the UK by Country of Birth and Nationality: 2015 (ONS, August 2016). This report included data from the Annual Population Survey (APS) showing that 13.3% of the UK's total resident population in 2015 were born outside of the UK.

A4.17 Table 4-2 shows labour market indicators for all those aged 16 or over living in Scotland. Of those born in non-UK countries around 232,000 were in employment. The economic activity and employment rates of those born outside of the UK are higher compared to the rest of the Scottish population. The unemployment rate for those born in non-UK countries is higher reflecting a higher tendency to actively seek work.

Table 4-2: Scottish Labour Market Indicators by Country of Birth (000s)

Labour market indicator	Born outside of UK	Rest of the Population	Population (Aged 16+)
In employment	232	2,343	2,575
Total population	429	4,861	5,291
Economic activity rate	65.8%	62.1%	62.4%
Employment rate	61.1%	58.4%	58.6%

SOURCE: Quarterly Labour Force Survey (Jan-Mar 2016)

A4.18 The figures shown in Table 4-2 are influenced by students. Of the 429,000 people living in Scotland that were born in other countries 48,000 (aged 16 or over) were in full-time education. Excluding those in full-time education (who also make a significant economic contribution to Scotland), the labour market outcomes for those born outside of the UK included an economic activity rate of 70.3%, an unemployment rate of 5.5% and employment rate of 66.1%.

Employment by Industry

A4.19 Table 4-3 sets out the share of workers born outside of the UK in each industry and the share of workers in each industry accounted for by those born outside of the UK.

A4.20 Nearly one third (31.8%) of all workers in Scotland, born outside of the UK, work in the public administration, education and health sectors, and they account for around one in nine workers (11.1%) in the distribution, hotels and restaurants industry.

Table 4-3: Industry of Main Job in Scotland, Those Born Outside the UK (000s)

Industry	Employment	Share of all non-UK born workers	Share of industry workers
Manufacturing (C)	20	8.5%	9.7%
Construction (F)	10	4.3%	5.7%
Distribution, hotels & restaurants (G,I)	61	26.6%	11.1%
Transport & communication (H,J)	17	7.3%	8.8%
Banking and finance (K,L,M,N)	34	14.8%	7.6%
Public admin, education & health (O,P,Q)	73	31.8%	8.8%
Other industries (A,B,D,E,R,S,T,U)	15	6.6%	6.4%
Total	**232**	**100.0%**	**9.0%**

SOURCE: Quarterly Labour Force Survey (Jan-Mar 2016)

NOTES: Standard Industrial Classification (SIC) 2007 sections A to U noted in brackets

A4.21 Those born outside of the UK account for 8.1% of all people living in Scotland but a higher share of the workforce (9.0%). If full-time students are excluded then those born outside of the UK account for 8.5% of all workers in Scotland.

A4.22 The pattern of industrial employment shown in Table 4-3 is markedly different in Scotland compared to other parts of the UK. For example, nearly one third of London's construction jobs were accounted for by those born in other EU countries.

A4.23 The pattern of industrial employment in Table 4-3 can be shown in terms of wages paid to employees in their main job. Table 4-4 shows the share of employee wages for those born outside of the UK accounted for by each industry and the share of employee wages accounted for by those born outside of the UK within each industry.

A4.24 Around 9.2% of employee wages in Scotland are paid to those born outside of the UK. This share rises to 15.0% in distribution, hotels & restaurants or more than one in every seven pounds paid to workers in the industry. Workers born outside of the UK account for more than one in every six pounds paid in wages within Scotland's manufacturing industry.

Table 4-4: Wages by Industry of Main Job in Scotland, Those Born Outside the UK

Industry	Share of all non-UK born workers	Share of industry workers
Manufacturing (C)	15.8%	17.3%
Distribution, hotels & restaurants (G,I)	16.7%	15.0%
Transport & communication (H,J)	5.4%	5.4%
Banking and finance (K,L,M,N)	20.9%	11.8%
Public admin, education & health (O,P,Q)	29.0%	7.1%
Other industries (A,B,D,E,F,R,S,T,U)	12.3%	6.0%
Total	**100.0%**	**9.2%**

SOURCE: Quarterly Labour Force Survey (Jan-Mar 2016)

NOTES: Standard Industrial Classification (SIC) 2007 sections A to U noted in brackets

A4.25 Within each industry, where the share of wages is higher (Table 4-4) than the share of employment (Table 4-3) this may be explained in part by the number of hours worked by those born outside of the UK. If full-time students were excluded then those born outside of the UK would account for 9.0% of wages.

A4.26 Scotland has the highest average hourly gross hourly pay outside of London for those born in other EU countries. This suggests EU workers are engaged in higher value added (more competitive) activities in Scotland compared to many other parts of the UK.

Economic Contribution

A4.27 Scotland's Input-Output Tables (July 2016) are used to produce macroeconomic models to simulate the economic impact of public policy. The tables include the most detailed breakdown available of income from employment by industry sector. Two approaches were used to estimate the overall income from employment for workers born outside of the UK. Firstly the overall share of employee income (9.2%) shown in Table 3.2 was applied to the measure of income from employment from the Input-Output Tables to estimate income from employment for workers born outside of the UK.

A4.28 The additional components of Gross Value Added (GVA) are 'taxes less subsidies on production' and 'gross operating surplus'. Income from employment is by far the largest component of GVA in Scotland. If the remaining components of GVA were also distributed using the same shares as for income from employment then an estimate of the contribution towards Scotland's GVA can be produced.

A4.29 Using the overall share of employee income (9.2%) the contribution of those workers born outside of the UK is £11.6 billion (in 2016 prices). The latest Input-Output tables are shown in 2013 prices and GVA was adjusted to 2016 prices using HM Treasury deflators.

A4.30 The second approach uses the employee income share for individual industries, shown in Table 4-4. This approach has the virtue of making more use of the data contained in the economic model and may better reflect the structure of the Scottish economy.

A4.31 Where employee income shares were not available for individual industries an estimate was based on the share of employment (summarised in Table 4-3). The second approach suggests the contribution of those workers born in other EU countries is £12.4 billion (in 2016 prices) accounting for 9.8% of the Scottish economy.

A4.32 These figures should be viewed as a snapshot of the contribution of workers born in other countries rather than the likely impact of any policy changes. For example wages, migration flows and employment levels are likely to adjust to policy changes.

A4.33 The wages paid to workers are a primary input but they also contribute to final demand. It may be more appropriate to apply forward linkage multipliers to wages showing how the inputs from workers help support sales to final demand markets. The development of economic models and multipliers is discussed in the Scottish Government's methodology guide.

A4.34 The industrial pattern of employment and income suggests workers born in other countries play a disproportionate role in supporting tourism markets (including hotels and restaurants) and export markets (manufacturing). It is not unreasonable to suggest that the role of these workers in Scotland is focused more on international markets than in the rest of the UK.

Government Revenues and Expenditure

A4.35 The Government Expenditure & Revenue Scotland (GERS) publication identifies 24 categories of revenue ranging from income tax to fuel duties. Based on the data shown in the Tables in the earlier sections of this chapter it is reasonable to assign some tax revenues on the basis of the share of Gross Value Added (GVA) attributed to workers born outside of the UK.

A4.36 The GERS estimates of revenue from income tax, national insurance contributions, corporation tax (excluding the North Sea) and VAT were allocated on the basis of 9.8% of Scotland's GVA attributed to workers born outside of the UK.

A4.37 VAT was also allocated on the basis of the GVA share as income is likely to reflect expenditure. However this share was adjusted downwards as expenditure is likely to arise from much wider sources of income aside from employment. These will include the state pension which people born outside of the UK as less likely to draw upon.

A4.38 It is difficult to estimate the likely impact on expenditure of people born outside of the UK and how different spending patterns would generate VAT revenues. The economy share of 9.8% was therefore reduced by 10% to give an effective share of 8.8%, this is closer to the population share of 8.1%.

A4.39 Other tax revenues were allocated on a per capita basis including gross operating surplus, fuel duties, council tax, tobacco duties, alcohol duties, vehicle excise duty, air passenger duty and betting and gaming duties. This was based population share of 8.1% shown in Table 4-1 and Table 4-2.

A4.40 Other taxes were excluded as it less than clear that there is a logical link between revenues and the economic activity of workers born outside of the UK. For example climate change levy and landfill tax. Table 4-5 shows the tax revenues associated with those living in Scotland born outside of the UK. Total revenues stood at £4.3 billion in 2015-16.

Table 4-5: Tax Revenues Associated With Those Born outside UK (2015-16)

Tax revenue	Value (£m)
Income tax	£1,191
VAT	£990
National insurance contributions	£914
Gross operating surplus	£308
Corporation tax (excluding North Sea)	£307
Fuel duties	£191
Council tax	£172
Tobacco duties	£96
Alcohol duties	£81
Vehicle excise duty	£37
Air passenger duty	£22
Betting and gaming duties	£18
Total revenues	**£4,326**

SOURCE: GERS and 4-consulting calculations

A4.41 A similar approach was taken in allocating expenditure. The GERS publication identifies 17 categories of expenditure ranging from health to transport. Based on the data shown in the Tables in the earlier sections of this report it is reasonable to assign some spending on the basis of the population share (8.1%) of those born outside of the UK living in Scotland.

A4.42 Accounting adjustments set out in GERS were excluded for both expenditure and revenue. Two further expenditure items were excluded; defence spending and public sector debt interest. These areas of expenditure were excluded on the basis that there is not a clear link between the population of those born outside the UK and spending on defence and debt interest.

A4.43 The population share was adjusted for three areas of expenditure including health, education and training and social protection. The LFS asks a series of questions around health including whether people have health problems, how long the health problems are expected to last and whether health problems are likely to limit the kind of work that people can do.

A4.44 Across a range of health questions those born outside of the UK living in Scotland were less likely to suffer from health problems. The share ranged from 5.1% to 5.3% of those with health problems, using a range of different health problem questions. This may partly reflect demographics.

A4.45 The LFS shows that more than one quarter (28%) of those born outside of the UK living in Scotland are in their thirties (aged 30-39) compared to just 11% of people born in the UK living in Scotland. Of those living in Scotland born outside of the UK only 8% are aged 65 or over compared to 19% of the rest of the Scottish population. A share of 5.3% was applied to health expenditure.

A4.46 Demography also plays a role in determining social protection expenditure. This includes the state pension, housing benefit and social care for the elderly. Those born outside of the UK account for around 2% of those receiving a state pension in Scotland, this was the largest component of social protection spending in Scotland.

A4.47 The state pension share (2%) is broadly in line with the age profiles of those living in Scotland born in and outside of the UK. A share of 5.3% was applied to social protection expenditure based on the weighted spending on the state pension, housing benefit and social care for the elderly.

A4.48 A share of 5.7% was applied to education which takes into account that those born outside of the UK account for 5.5% of school age children (those aged under 16). Spending associated with schools accounts for the largest part of education spending.

A4.49 This share was adjusted upwards to take into account spending associated with university tuition fees (based on the latest Audit Scotland report on higher education). EU students were estimated to account for around 12% of students for whom tuition fees are paid for by the Scottish Government.

A4.50 Spending associated with those born outside of the UK is set out in Table 4-6 below:

Table 4-6: Spending Associated With Those Born outside UK (2015-16)

Spending	Value (£m)
Social protection	£697
Health	£645
Education and training	£456
Transport	£261
Public order and safety	£230
Recreation, culture and religion	£116
Public and common services	£113
Housing and community amenities	£110
Environment protection	£100
Enterprise and economic development	£84
International services	£68
Agriculture, forestry and fisheries	£68
Science and technology	£40
Employment policies	£18
EU Transactions	£17
Total	**£3,025**

SOURCE: GERS and 4-consulting calculations

A4.51 Table 4-7 summarises total taxes, spending and the net balance associated with those born outside of the UK living in Scotland.

Table 4-7: Spending 2015-16

Spending	Value (£m)
Total taxes	£4,326
Total spending	£3,025
Total taxes minus total spending	**+£1,302**

Migration and Population Trends

A4.52 The National Records of Scotland (NRS) produces a range of population projections based on different scenarios. The most recent population projections are shown over 25 years with a starting point of 2014.

A4.53 The main (principal) projection shows Scotland's population rising from 5.35 million in 2014 to 5.51 million by 2024 and continuing to grow to 5.7 million by 2039. Over 90% of the increase in population up to 2024 is projected to arise from continuing inward net migration to Scotland.

A4.54 NRS also publish variant projections including high and low migration scenarios. A scenario is also provided with no migration and where the projected change in the level of population is due to natural change (the difference between births and deaths).

A4.55 There difference between the scenarios where there is no migration (natural change only) and the high migration scenario is projected to be around 754,000 people over the 25 year period. Additionally, a scenario of natural change results in a much older population with a larger share of the population of retirement age.

A4.56 The NRS also provide long term population projections over 60 years. At the end of the 60 years the high migration scenario shows the Scottish population standing at 6.8 million compared to 4.3 million in the natural change scenario, a difference of around 2.5 million. The economic performance gap between those two scenarios would be very significant indeed.

Origin of Migrants

A4.57 The number of people born outside of the UK living in Scotland is shown in Table 4-8 by the top five countries of birth. Poland accounts for one in five people (20%) living in Scotland who were born outside of the UK.

Table 4-8: Top 5 Countries, Born Overseas Living in Scotland

Country of Birth	Resident Population	Share of Population Born Overseas
Poland	87,000	20%
United States	26,000	6%
Germany	22,000	5%
Republic of Ireland	22,000	5%
India	21,000	5%
Total	**429,000**	**100%**

Source: Quarterly Labour Force Survey (Jan-Mar 2016)

A4.58 The sample size was too small to allow estimates to be made for some of the impacts shown in this report for each country of birth. As an approximate guide the share of the population born overseas could be used to estimate the likely impact.

A4.59 For example, those born in Poland and living in Scotland may be associated with £865 million of taxes, make a net contribution of £260 million to the public purse and £2.5 billion in GVA.

Conclusion on International Citizens

A4.60 There are around 429,000 people living in Scotland who were born outside of the UK, accounting for around 8% of Scotland's total population. Those born in other countries but currently living in Scotland are more likely to be economically active, more likely to be in work and more likely to look for work.

A4.61 Around one in every eleven workers (9%) in Scotland was born overseas. Migrant workers are most strongly represented in Scotland's hospitality and manufacturing sectors. However, there are more workers born overseas working in the public sector (73,000) than in manufacturing (20,000).

A4.62 Around 9% of the total value of employee wages in Scotland is paid to those born other countries. The higher share of employee income may be explained in part by those born in other countries working longer hours.

A4.63 Using an economic model and underlying data published by the Scottish Government the economic contribution of workers born in other countries was estimated to be around £12.4 billion in Gross Value Added (GVA) each year. This accounts for 9.8% of Scotland's economy.

A4.64 These figures should be viewed as a snapshot of the contribution of workers born in other EU countries rather than the likely impact of any policy changes. For example wages, migration flows and employment levels are likely to adjust to policy changes.

A4.65 The industrial pattern of employment and income suggests Scottish workers born overseas play a disproportionate role in supporting Scotland's tourism markets and export markets. The role of workers from other countries in Scotland is focused more on international markets compared to the rest of the UK.

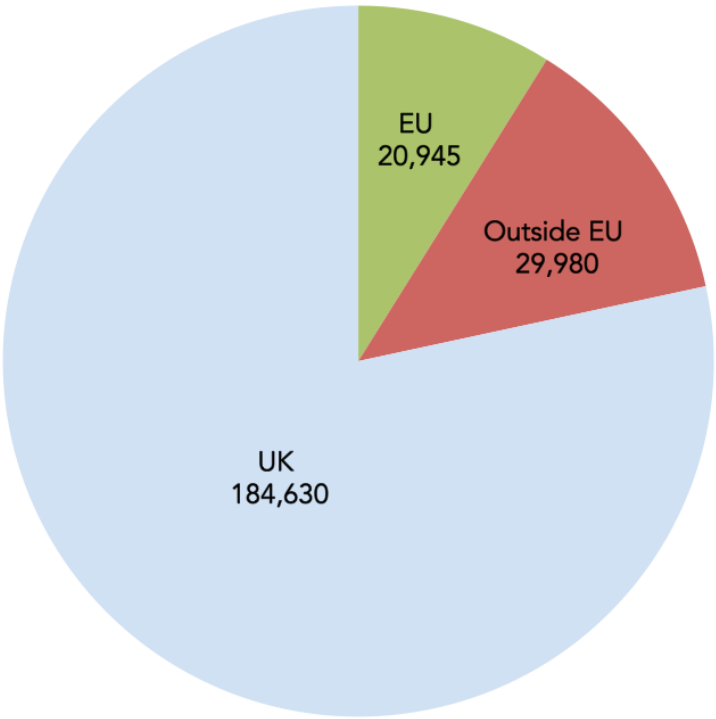
A4.66 The 429,000 Scottish residents who were born overseas are associated with £4.3 billion of government revenue, including income tax and national insurance contributions. Government spending associated with Scottish residents who were born overseas stood at £3.0 billion. This suggests a net contribution to Scotland's public purse of £1.3 billion.

International Students

A4.67 The global market for international students has grown significantly over the last few decades, with Scotland and the UK as a whole having been very successful in attracting overseas students. In the academic year 2015-16, approximately one in five students enrolled in Scottish higher education was from outside the United Kingdom. Of these

overseas students approximately three in five were international students from outside the European Union and two in five were students from within the European Union. Figure 4-2 shows the number of students enrolled in Scottish higher education institutions by domicile in 2015-16.

Figure 4-2 – Students enrolled in Scottish higher education institutions by domicile, 2015-16



Source: Higher Education Statistics Agency Limited (2017)

A4.68 The number of students worldwide enrolled in tertiary level education outside their country of origin has greatly increased since 1999. The UNESCO Institute for Statistics (UIS) estimates that this has more than doubled from around 2 million in 1999 to 4.6 million in 2015. Scotland, therefore, attracted more than 1.1% of the global total number of international students, which far exceeds Scotland's 0.07% share of the global population. The UK performed equally well, attracting 9.5% of worldwide international students, second only to the US at 19.7%.

A4.69 International students are of great academic, economic and cultural importance to the Scottish higher education sector and the country more broadly. Students from out with the European Union are subject to tuition fees, whereas students from within the European Union are entitled to have their fees paid by the Students Awards Agency for Scotland (SAAS).

A4.70 The tuition fees that are paid by international students enrolled at a Scottish university are a direct transfer into the Scottish economy and therefore make a positive contribution to Scotland's (or the UK's) balance of trade with the rest of the world. Similarly, the money

that overseas students also spend throughout the year is also a direct transfer into the Scottish economy from the rest of the world. By adding together these sources of income it was estimated that approximately £1.1 billion in exports in 2015-16 was attributable to overseas students studying in Scotland. The contribution that overseas students make to the balance of trade can also be expressed in per capita terms.

A4.71 Each student from out with the EU generated £26,811 in exports for the Scottish economy in 2015-16 and each student from within the EU generated £14,812.

A4.72 However, given that much of the spending of students is consumer spending in Scotland, like tourism exports these figures are not fully reflected in reported export statistics.

A4.73 Overseas students in Scotland also make a net positive contribution to the UK Exchequer. In 2015-16 a typical overseas student in Scotland accounted for approximately £7,500 in taxation revenues and consumed around £5,000 in public services. This gives a net fiscal benefit of around £2,500.

A4.74 However, restrictions to the post-study work visa for international students limits the potential fiscal benefits. The tightening of immigration controls over the past few years has severely limited the number of international students who remain in Scotland after graduating. As a result of this, Scotland is losing out on the tax revenues associated with the additional earnings of some of these international students who would otherwise have stayed in Scotland.

A4.75 International higher education is becoming an increasingly competitive market, with countries around the globe actively seeking to attract more international students to their own universities. This is happening at the same time as the UK continues to restrict international graduates' post-study work opportunities, and include overseas students within a wider ambition to significantly reduce the levels of net migration. The success of Scotland's universities in attracting overseas students should not automatically be assumed to continue in the current context. Reducing or removing the current restrictions to international students will help to maintain Scotland's success in attracting overseas students, benefiting Scotland's economy and public finances in the coming years.

Attracting Investors, Entrepreneurs and Talent to Scotland

A4.76 Few Scottish families have been untouched by the loss of sons, daughters, nieces, nephews and other family members to emigration. It has been a perpetual drain on our economy. Often those leaving have been attracted by both the welcome and economic incentives available elsewhere. They have been the pioneers of the new world. It is time for Scotland to learn the lessons of how to attract the best and brightest to create a modern, dynamic society and economy. We need to have more pioneers in our own country.

A4.77 We also want to tap into the goodwill being shown in so many ways by people from other parts of the UK. We know some wish to move to Scotland and bring their talents to find a

more secure, outward looking and progressive home. They will find a ready welcome in Scotland.

A4.78 There should be six priority groups for Scotland to attract from an economic perspective:

- Investors, wanting to come here to invest in creating jobs and opportunities and enjoy the benefits of a welcoming and vibrant society.
- Entrepreneurs wanting to harness the talents of our universities, colleges and skilled population to create the businesses of the future
- The highly skilled who will bring much needed expertise to help further improve our productivity and growth.
- Returning Scots wanting to bring their skills and talents to help build the new Scotland.
- People from the rest of the UK who wish to bring their skills and talents to Scotland and be part of building a progressive, outward looking nation.

A4.79 This by no means is intended to restrict anyone. Family ties with Ireland, for example, continue to provide a rich source of mobility in both directions. These 5 priorities are meant as just that, initial areas of marketing focus.

International Government and Multi-national organisations

A4.80 In addition there should be a coordinated and professional engagement with the full range of foreign governmental representatives (diplomatic, and cultural) and the full range of international organisations to seek to locate teams, functions and headquarters in Scotland. With the correct positioning, professional engagement to ease decision making transition there could be a strategic effort to attract many more organisations and people to base themselves in Scotland both facing into the developing Scottish system and market and also as a place from which to work with the rest of Europe and the world.

A 'Come to Scotland' Package to welcome talent

A4.81 Often, the biggest and most profound changes in economies are not driven by tinkering with economic policy, but by major political and social choices. So it should be in Scotland.

A4.82 A key requirement is to completely break from the xenophobic rhetoric so prevalent in the UK as a result of the debate surrounding the EU referendum, and the domination of a narrow and inward-looking immigration debate. This ranges in extremes but even the milder nods in the direction (dog whistling) create severe discord and economic self-harm.

A4.83 Just as generations of Scots have helped build Australia, Canada, New Zealand and many other nations, so too must Scotland offer the best of an open and welcoming society to those wishing to become new Scots in a new Scotland. Such a cultural outlook will have very positive economic and social consequences.

A4.84 Currently the UK has a very harsh series of measures in place that present significant barriers to attracting the type of individuals who could do so much to help us build a new Scotland. Scotland must make its own policies, to suit our own people and build our own future. A 'Come to Scotland' package would include:

Investors

A4.85 There has been only a trickle of investors in recent years attracted to the UK. In part, this is due to the current UK requirement of investors from outwith Europe to have a minimum of £2 million readily available for investment in British business, and £10 million if you wish to permanently settle after two years[33]. So, if you only have, say, between £250,000 to under £2 million available, neither you nor your investment is welcome on a visa, and if less than £10 million you are not welcome to stay.

A4.86 Yet in the Scottish economy dominated by small and medium sized companies, the increased level of investment funds available from, say, an additional 1,000 people bringing on average an additional £1 million each for investment in Scotland would increase investment funds by £1 billion pounds which through investment would create much more than £1 billion in economic value to the Scottish Economy. Scotland therefore should welcome investors with as low as possible an investment threshold of capital to invest in Scotland, and should consider granting investors an easy route to permanently settle here and invest in Scottish businesses. The exact amount should be consulted on to ensure that unintended consequences are contained but with the initial aim of agreeing a threshold that is a small fraction of the current UK level. Consultation should begin at £75,000.

Entrepreneurs

A4.87 Individuals with great new business ideas wanting to come to Scotland at present to create new businesses and tap into our network of universities and colleges also face barriers placed in their way by the UK Government. Such barriers for non-European entrepreneurs include having a minimum of £50,000 to invest in their start up, and proof they can sustain themselves within Scotland from their own additional funds. The rejection rate of those who had the £50,000 available has been as high as 70% in recent times and is typically over 50%.

A4.88 Scotland could do three things to ensure we attract the businesses of the future. First, allow entrepreneurs up to six months in Scotland working with bodies such as Scottish Enterprise before having a final detailed business plan. Secondly, in light of the fact many indigenous Scottish entrepreneurs start out with next to nothing, drop the £50,000 limit to, a much lower threshold which can be consulted upon to ensure that unintended consequences are contained. Third reduce the excessive visa and other costs to entrepreneurs to bring such costs in line with normal rates.

[33] Source: UK Government (www.gov.uk/tier-1-investor)

Highly skilled – easing the cost of transition

A4.89 We must remember that each immigrant worker is an emigrant from his or her own land. Just as skilled emigrants from Scotland often received some economic incentives, so Scotland must look to providing competitive incentives to attract the best and the brightest. This could take a number of forms. An example of one such policy initiative, could be to consider a "transition relief" allowing defined costs of moving and housing in the first year to be set against income tax, with a potential ceiling placed on such relief agreed in consultation to ensure the unintended consequences e.g. on the housing market are contained. The main effects would be firstly financial easing transition costs, and secondly cultural in nature, sending a signal about the type of society Scotland is, welcoming new Scots. This policy should be costed by the Scottish exchequer and advertised with vigour to the rest of the UK and the world. It is anticipated that the net exchequer impact of this policy will be significantly revenue enhancing over a short number of years and marginal in initial costs given it is incremental on relatively low current migration flows.

Visa costs

A4.90 Currently the UK has a complex system of visas and associated administrative requirements that means a family moving to the UK can face charges of many thousands of pounds, and without significant guarantees of long term rights. The current system in the UK would be costly and inefficient for Scotland to mimic. Scotland should set in place a simplified visa system avoiding unnecessary administrative burdens. An immediate project to identify the best and most effective international example should be undertaken and plans made to replicate or improve on it here.

Students

A4.91 Scotland's universities attract around 50,000 international students, who make a contribution to the economy and a new fiscal contribution whilst they are students, as well as making an important contribution to the diversity and vibrancy of university campuses and the cities and towns in which they are located. However, UK visa restrictions mean that most non-EU students have to leave within 3 months of completing their studies, and the position of students from other EU countries is uncertain given Brexit.

A4.92 Whilst some international students will have the intention of returning to their countries of origin, or to another country on graduation, a substantial proportion would be interested in staying in Scotland, and their knowledge and skills can make an important contribution to addressing the productivity challenges in the Scottish economy (discussed in chapter A6).

A4.93 Changing the visa requirements to allow more international students to stay may well be sufficient to encourage more to do so. However, to ensure that Scotland continues to be a competitive location and in recognition of the contribution already made to the economy and the exchequer, we recommend that international graduates from Scottish universities

that stay and work in Scotland should also be incentivised to do so via the taxation system, for the first three years.

A4.94 Retaining an additional 5,000 international graduates per year would deliver economic and exchequer benefits. Based on average salaries[34] of £30,000 and one-third of that paid in the form of taxes on income, within a decade this would deliver an economic contribution of £1.5 billion per year and annual revenues to the exchequer of £500 million.

Key recommendations

A4.95 **Population growth**: Targeting a growing population of working age and the attraction of talented migrants should be a top priority of Scottish Government economic policy and marketed vigorously to the rest of the UK and the world. Scotland should seek to be regarded as the most talent friendly country in the world.

A4.96 **A new 'Come to Scotland' package** should be created with a package of incentives including:

- A 'transition relief' package of tax incentives to reduce the cost of moving to Scotland, and for graduates of Scottish Universities to stay on should be the headline instrument.
- A reduced capital threshold for investors who are required to provide this
- A reduced investment threshold for business start-ups
- A new visa system benchmarked on the most efficient and easy to use in the world

A4.97 **Marketing of 'Come to Scotland:** The marketing of this package and the overall approach should be a major part of the country's international and UK marketing investment and the communications strategy for the internationally facing Scottish agencies. As far as possible the intention will be to secure cross partisan support for the whole approach which also attracts engagement from our major employers, exporters and universities. The budget should reflect the priority as should the engagement of senior Ministers and officials.

A4.98 **Celebration of the contribution of migrants**: A complimentary programme of internally focused public engagement on the contribution of our migrant and 'new Scots' communities should be embedded in the work of the Government, Local Authorities and across Parliament.

A4.99 **International Students and Graduates**: The attraction and retention of international students should be a priority of policy and changes made immediately to alleviate the constraints caused by UK policy. These changes should include both visa changes to allow more students to stay in Scotland long enough to secure employment appropriate to their

[34] After 5 years, median graduate salaries in Scotland vary between £19,700 and £48,000, depending on subject (Source: Scottish Government (2017), Graduate Outcomes by University and Subject (LEO data) Scotland)

qualifications and tax incentives for the first three years of employment (in recognition of the social, economic and exchequer contributions already made).

A4.100 **International Government and Multi-national Organisation Strategy**: One of the existing internationally facing elements of the Government or indeed a combined international department or agency should be tasked with creating a strategy for engagement and transitioning of the staff of international governments and multi-national organisations to Scotland. As well as providing a great home for countries and organisations that wish to engage with Scotland the strategy should aim to provide a home for as many international facing organisations in function or headquarter as is possible. A warm welcome should be matched with a professional service to ease transition cost-effectively.

A5 PARTICIPATION & INCLUSIVE GROWTH

- There is an economic as well as moral imperative to improve participation and equality. A long-term cross partisan strategy is required.
- International Monetary Fund and World Economic Forum studies identify a direct relationship between improved inequality and growth.
- In income and gender pay inequality Scotland underperforms many of the benchmark small advanced economies to its economic, social and fiscal disadvantage.
- The direct cost of inequality on the Scotland's net fiscal position is estimated at more than £6.4 billion per year.
- The Joseph Rowntree Foundation targets a position where less than 10% of the population are in poverty at any one time. This would be a reduction of 50%, if achieved this could mean a saving of £1.6 billion to the Scottish public finances.
- OECD data show that many small advanced economies have gender pay gaps that are less than half that of Scotland. Median full-time workers in New Zealand are paid 94.4% what the median full-time male worker is paid, compared to 83.4% in Scotland.
- If gender inequality in Scotland was reduced to the level of New Zealand, Scottish GDP would grow by £6.1 billion and the net impact on public finances would be a possible positive net exchequer impact of up to £3 billion.
- Regional inequality within Scotland is less stark than within the UK but requires addressing.
- More localised inequality also needs to be addressed, targeted at the groups in society who have faced significant barriers to full participation in the economy, even in times of economic growth. This will require concerted long-term action to ensure that no one is excluded from opportunities that the majority of us take for granted.

A5.1 As noted in chapter A1 Scotland's performance on the participation component was reasonable relative to the UK in the first decade after devolution but has decline in comparison since. Making an impact on widening participation at all levels of society is a crucial part of creating the sort of modern progressive society most people in Scotland wish to live in.

A5.2 In reflecting on the challenges policymakers face in this area we concluded that an initial and strong benefit will come from understanding and communicating the longer-term benefits of solving the problem. All governments of all parties would like to have more people participating, the problem is not one of intent. However, taking the decisions to allocate risk bearing resource for the long-term on the hardest pressed groups and communities has proven a material challenge for all governments.

A5.3 Once again this points up the need for longer term cross partisan agreement and strategies to be agreed. For many critics of policymakers this can often be seen as putting 'good money after bad'. As a result, resource shifts to alleviating the symptoms of non-participation in health, crime and social outcomes. This seems both understandable but unsustainable. This is further reinforced by the current package of financial competences for Holyrood which as a result of their restricted nature tends to limit policy options to a narrow approach of making marginal additions to or deductions from the decisions of the UK Government and Treasury. Clearly, a full-range of tax and social security powers would enable the current, and any subsequent, Scottish Government to consider other measures, affecting longer term incentives, behaviour and therefore economic and fiscal outcomes.

A5.4 Inclusive Growth is, of course, one of the four key pillars of the current Scottish Government's economic strategy and making Scotland a more equally participative society will be an issue for successive governments at Holyrood. Inclusive Growth means that everyone is included in the growth that a country has, regardless of where in the country they live, their gender, ethnicity or socio-economic status.

> *Inclusive Growth: Growth that combines increased prosperity with greater equity; that creates opportunities for all and distributes the dividends of increased prosperity fairly*
>
> (Scottish Economic Strategy 2015)

A5.5 This chapter considers:

- How inequality impacts on growth levels
- The current state of inequality in Scotland
- How government policies can influence inequality.

Inequality and Growth

A5.6 The relationship between the level of inequality in a country and growth in that economy is mixed, however the view that higher growth necessitates higher inequality becomes obsolete under analysis. Some economic theories had considered inequality a necessary driver of economic growth as it increases incentives and each person in the economy is paid in line with their marginal productivity. However, more recent thinking on this debate has highlighted flaws in these theories and suggests that the relationship between economic growth and inequality could be negative. This view marks our starting point.

Organisation for Economic Co-operation and Development

A5.7 The OECD has highlighted inequality as one of the key areas of research and published a summary of their findings in 2014[35]. This analysis found that the gap between the rich and

[35] OECD (Dec 2014), "Focus on Inequality and Growth - December 2014"

poor in society is at its highest level in 30 years and that this increase in inequality has significantly curbed economic growth. The main driver for this relationship is that people from disadvantaged social backgrounds are discouraged from investing in their education.

A5.8 The OECD analysed the numeracy scores of adults, as a proxy for human capital, and found that the proportion of individuals whose parents had low levels of education decreases as income inequalities rise. In other words, individuals from lower income brackets are less likely to invest in education, which widens the gap between themselves and those at the top. This analysis[36] found that in a society like Scotland, with a Gini coefficient of 0.31 (defined in A5.20) individuals with a low parental educational background would have a numeracy score 4% lower than individuals from the same background in a country with a Gini coefficient of 0.2.

A5.9 In 2105, the OECD published 'All on Board: Making Growth Happen'[37] that called for a multidimensional framework approach for tackling the multidimensional reality of inequality, in particular because rising income inequalities can lead to inequalities in health and educational outcomes being further entrenched in societies. These health and educational outcomes can, in turn, reduce the ability to tackle long term income inequalities.

International Monetary Fund

A5.10 In 2011, the IMF published research into the implications of inequality on the rate of economic growth[38]. This study had three main findings, which were:

- more unequal societies redistribute more;
- lower net inequality is robustly correlated with faster and durable growth, for a given level of redistribution; and
- redistribution appears generally benign in terms of its impact on growth; only in extreme cases is there some evidence that it may have direct negative effects on growth.

A5.11 Countries with higher levels of market inequality may have reduced and less sustained growth as this market inequality drives same redistributive policies that undercut growth. As part of the UK, Scotland has a comparatively high level of market income inequality that is adjusted through Government redistribution programmes.

A5.12 The IMF's work on inequality has also identified the instability of growth that is based on less equal economies. It found that inequality will amplify the potential for financial crises,

[36] OECD (2015) In it together, Why Less Inequality Benefits All
[37] OECD (2015) All on Board: Making Growth Happen
[38] Berg & Ostry (2011). "Equality and Efficiency" Finance and Development (International Monetary Fund), September 2011, Vol. 48, No. 3

cause political instability, reduce educational and investment opportunities for less well-off individuals and reduce the ability of governments to react properly to economic shocks.

The Price of Inequality

A5.13 One of the leading thinkers in the impacts of inequality on economies is Nobel-laureate Professor Joseph Stiglitz. In 2013, he published The Price of Inequality[39] which focused on the drivers and implications of inequality in the USA. In addition to the detrimental impact of market inequality on education and of some redistributive policies, Stiglitz also identifies power structures that are enhanced by unequal societies and therefore builds in incentives for the benefactors of inequality to maintain these systems.

A5.14 Stiglitz highlights the consolidation of wealth and economic power within 'the 1%' as a symptom and cause of inequality, particularly through the increase in rent-seeking over the past decades. In particular stagnant wages, despite increased productivity over this time period, is evidence that the share of the benefits of production is not being distributed at source; rather those with the power to retain it are retaining it.

A5.15 The increase in inequality can have both long and short-term implications for growth. In the short term, consolidation of income at the top will result in lower levels of aggregate demand in the economy as top-level earners save a much greater proportion of their income. This increase the slowdowns in employment and recessions. In the long-term, wealth and income consolidation can reduce the levels of public investment in the infrastructure, institutions and individuals required for long-term economic growth. This is a result of detachment of those at the top from the need for such public services. For example, if those in power use the private schooling system, investment in the state schooling systems becomes less of a priority for them. Similarly, for public healthcare or transportation. However, reductions in investment in these areas has serious negative implications for the long-term economic productivity of a country and the incentives for business investment in that country.

Current Inequality in Scotland

A5.16 Inequality in Scotland is multifaceted. There currently exist inequalities between the highest paid and the lowest paid, between men and women, between immigrants and those born in the UK, and a number of other determined factors that can define an individual's life chances. This section considers the current status of:

- income distribution and wealth inequalities;
- gender inequality; and
- regional economic inequalities.

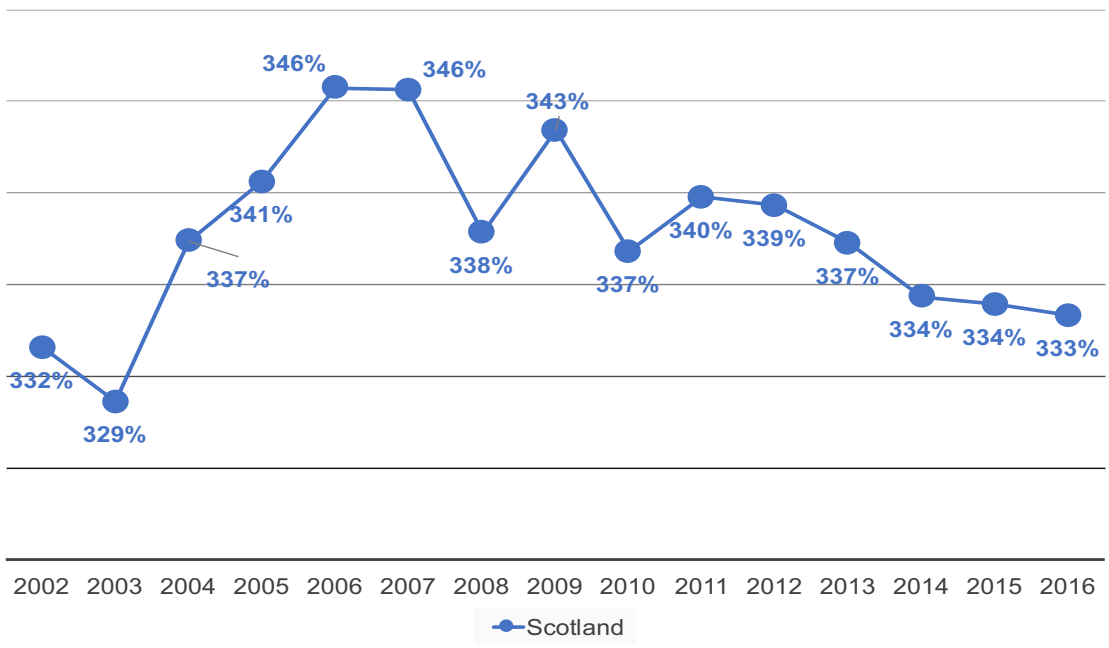
[39] Stiglitz (2013) The Price of Inequality, Penguin

Income distribution

A5.17 There are many measures of income inequality in an economy. These are not all correlated and therefore one measures can show inequality decreasing, while others will show inequality in the same economy getting worse over the same period.

A5.18 One of the most common measurement of inequality is the difference in earnings from those at the top of the income bracket and those at the bottom. In Scotland, for full time workers in 2016 the top 10% of earners had an average income of £52,248, while the bottom 10% had an average annual income of £15,675[40]. Therefore, the top earners had an income 3.33 times greater than the lowest earners. The 90/10 ratio is an indicator of market income inequality and gives a guide on how the rewards of employment are split between the economy but does not include the effects of redistribution by government.

Figure 5-1 – 90/10 Ratio of Full Time Earners in Scotland 2002 - 2016



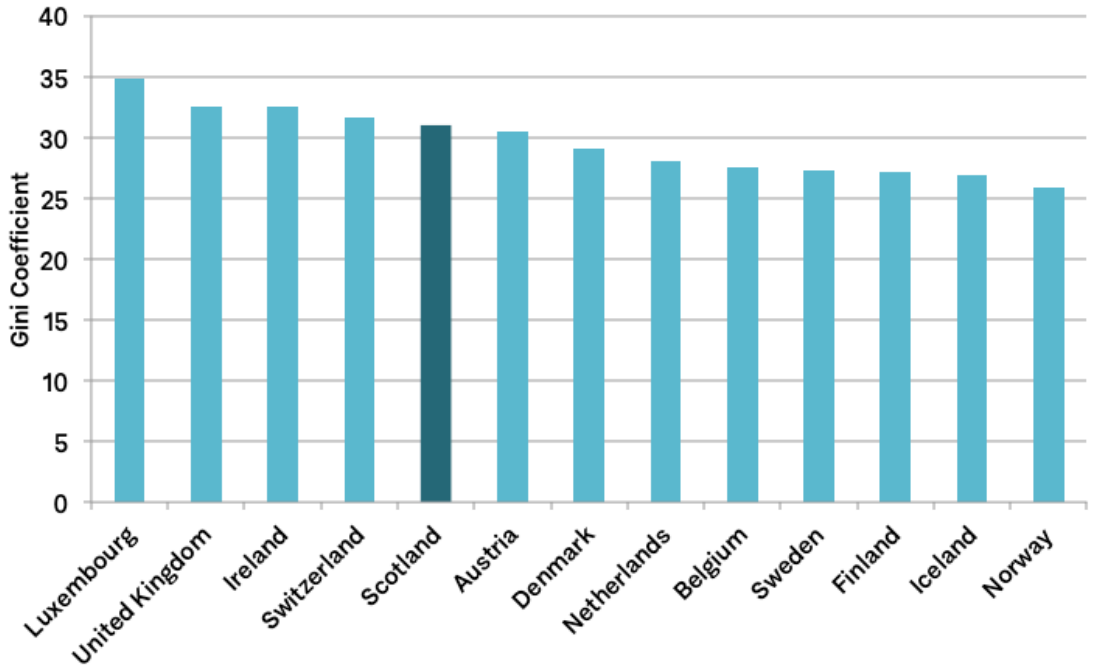
Source: ONS Annual Survey of Hours and Earning

A5.19 Since 2002 the 90/10 ratio in Scotland has not changed drastically, although it did peak in 2006/07 at 3.46. By this measure, the level of income inequality has slowly decreased each year since 2011. Throughout this time period the level of income inequality in Scotland has been lower than that of the UK as a whole. This is not primarily because those at the lower end of the income bracket have earned more, but rather because those at the top have earned less. In 2016 those in the lowest percentile in Scotland earned £285 more than their counterparts in the UK, while those in the top 10 percent earned £3,968 less than the top 10% of earners across the UK.

[40] ONS (2016), Annual Survey of Hours and Earning - Resident Analysis 2016

A5.20 The Gini coefficient is another measure that is used to compare income inequality across countries. This enables the level of inequality in Scotland to be put in an international context. A higher Gini coefficient in an economy indicates a higher level of inequality in that country. The latest available data through the World Development Indicators are for 2012. In 2012, the Gini coefficient in Scotland was 31, which was lower than the Gini coefficient for the UK, which was 32.6, due to fewer very high earners in Scotland. However, income inequality is higher in Scotland than in other countries such as Austria, the Netherlands, Belgium and the Nordic countries.

Figure 5.2 - Gini Coefficient in 2012



Fiscal Implications of Income and Wealth Inequality

A5.21 The persistence of income inequality and poverty in Scotland also has a direct effect on the public finances of Scotland. A study by the Joseph Rowntree Foundation[41] found that the total costs of poverty in the UK were approximately £78 billion and that approximately 20% of all public expenditure is directed to counteract the detrimental impact that poverty has on the lives of those affected. Based on an approximate population share this would imply that the social costs of poverty in Scotland is equivalent to £6.4 billion. The source of these costs is given in the table below.

[41] Joseph Rowntree Foundation (August 2016), Counting the cost of UK poverty

Table 5-1 – Costs of Poverty

Expenditure heading	UK total (£bn)	Scottish population share (£bn)
Acute hospital	21.8	1.8
Primary health care	7.1	0.6
Public health	1.6	0.1
Children and families personal social services	5.9	0.5
Children and families nursery/early years	1.6	0.1
Adult social care - younger	2.4	0.2
Schools	10.1	0.8
16 - 19 education	1.1	0.1
Higher education	0.4	0.0
Housing investment	2.7	0.2
Housing current	1.4	0.1
Police	5.0	0.4
Criminal justice	3.9	0.3
Fire and rescue	0.8	0.1
Transport - concessions and bus subsidies	0.5	0.0
Local environmental services	0.9	0.1
Total public service costs	69.2	5.7
Knock on effects	8.7	0.7
Total costs of poverty in UK	**77.9**	**6.4**

Source: BiGGAR Economics Analysis

A5.22 The Joseph Rowntree Foundation (JRF) has published a strategy for governments, businesses, communities and citizens[42]. In this strategy, the JRF lays out a vision for poverty in the UK in which less than 10% of the population are in poverty at any one time. This would be a reduction of 50% compared to the current 13 million people who are in poverty now. Even if only 50% of this target was achieved, assuming savings were proportional to the number of people in poverty, this would result in a saving of £19.4 billion the UK public sector and £1.6 billion to the Scottish public sector.

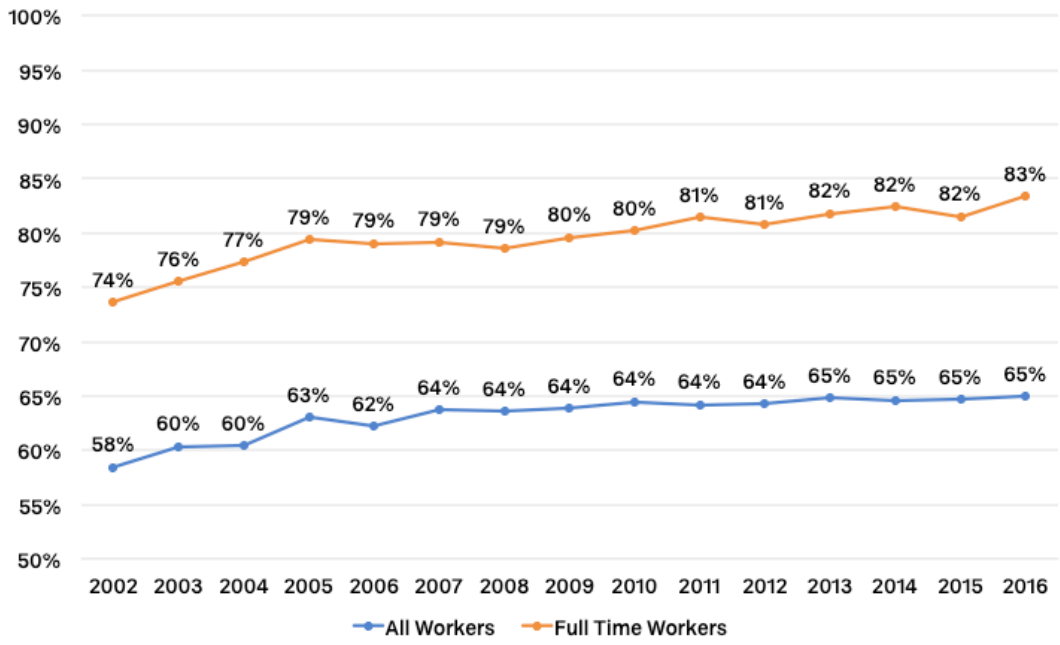
Gender Inequality

A5.23 One of the most important factors in determining an individual's annual income is their gender. In 2016 the average female worker was paid 65% of the level of the average male worker. There are a number of factors that contribute to this, such as a higher propensity

[42] Joseph Rowntree Foundation (2016), *We can solve poverty in the UK*

for female workers to work part-time. However, even when only full-time workers are considered female employees earn 83% the level of male full-time employees. Both of these metrics have seen improvements since 2002, as male and female pay have slowly converged. At that time the median income of female workers was 58% that of male workers, while full time female workers only earned 74% the level of their male counterparts.

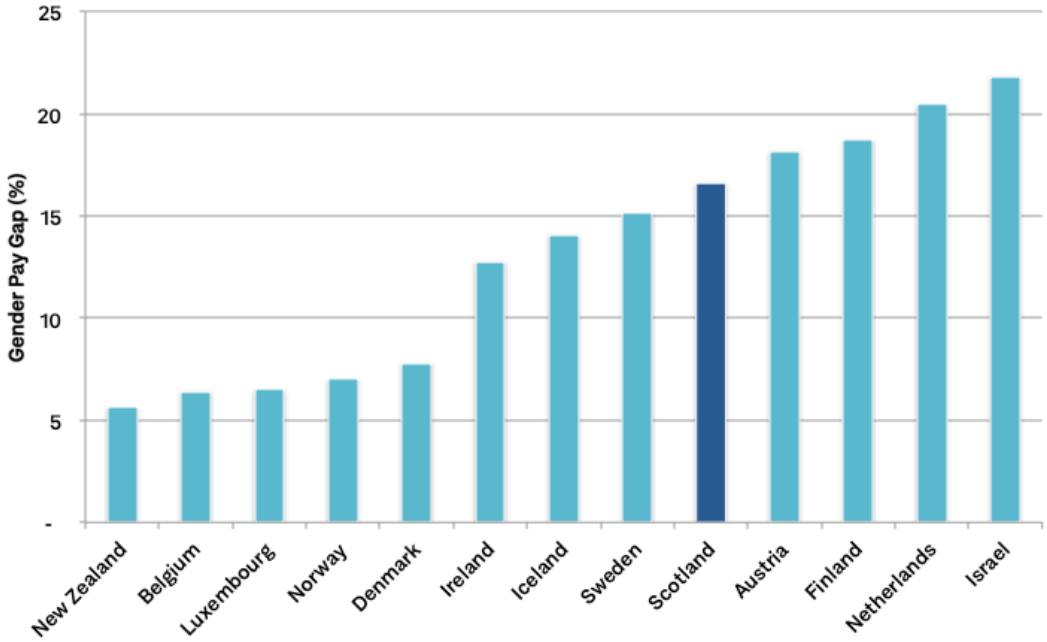
Figure 5.3 - Female median annual pay as proportion male median annual pay



A5.24 Scotland has a lower gender pay gap than the rest of the UK. However when compared to other small advanced economies, Scotland's performance does less well. Data from the OECD[43] shows that many small advanced economies have gender pay gaps that are less than half that of Scotland. Median full-time workers in New Zealand are paid 94.4% what the median full-time male worker is paid, compared to 83.4% in Scotland.

[43] OECD Employment Database 2014

Figure 5.4 - Gender pay gap of full time workers



A5.25 The implications for growth in closing the gender gap are significant. Analysis of the Annual Survey of Hours and Earnings (ASHE)[44] shows that female full-time workers are expected to earn 31.7% of all annual pay in Scotland in 2016. If this was equivalent to the contribution of full-time female employees to the £147 billion Scottish GDP[45], then even modest improvements in the gender pay gap could lead to significant increases in national GDP. If full-time female earnings were increased so that the gender pay gap in Scotland was reduced to the level of Sweden, Scottish GDP could be £0.8 billion higher. If it was reduced to the level of New Zealand, Scottish GDP could increase by £6.1 billion.

A5.26 In 2016/17, total Scottish public sector revenues were the equivalent of 38.5% of the onshore economy[46]. Therefore, an increase in GDP of £0.8 billion could be expected to increase public revenues by £0.3 billion while an increase in GDP of £6.1 billion could be expected to increase public sector revenues by £2.3 billion. At the same time the call on public expenditure could be expected to reduce. And while we haven't been able to model this precisely it could suggest a total positive net exchequer impact of up to £3 billion other things being equal over time.

[44] ONS (2016) Annual Survey of Hours and Earnings for Scotland

[45] Scottish Government (2016), Quarterly National Accounts Q1 2016

[46] Scottish Government (2017), Government Expenditure & Revenue Scotland 2016-17

Table 5-2 – GVA Impact of Reducing Gender Wage Gap

Country	Full Time Gender Wage Gap	Increased GVA in Scotland	Increase Public Sector Revenues
Scotland	16.6%	-	-
Sweden	15.1%	£0.8 billion	£0.3 billion
Ireland	12.8%	£2.1 billion	£0.8 billion
Denmark	7.8%	£4.9 billion	£1.8 billion
New Zealand	5.6%	£6.1 billion	£2.2 billion

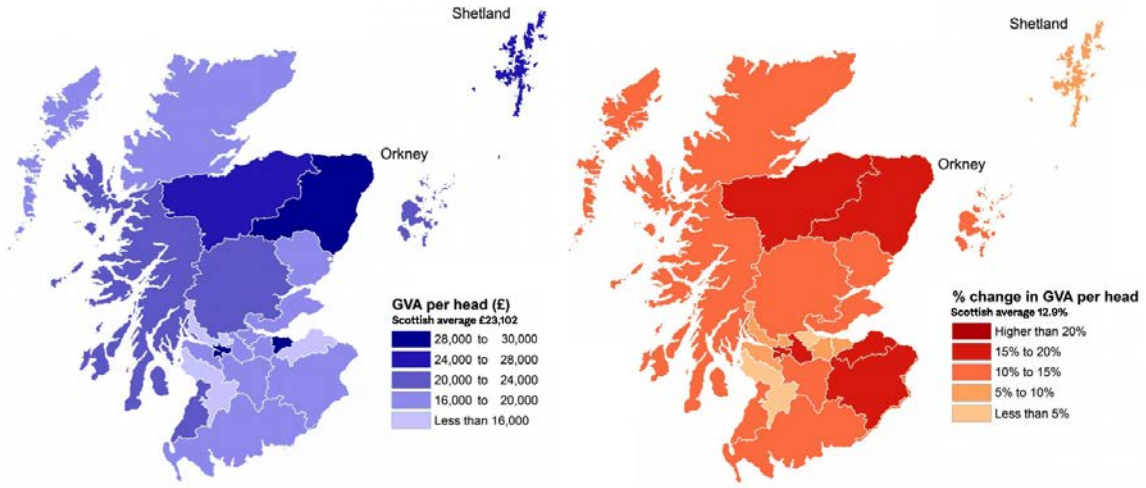
Source: BiGGAR Economics Analysis

Regional inequalities

A5.27 Many of the issues contributing to inequality are national, such as the disparities in the gender pay gap, and are likely to be addressed by Government with national policies. However, as is shown below, the regional inequalities within Scotland are growing and in order to address the issues that contribute to this divergence there will need to be more locally orientated policies and initiatives that address the specific problems of these communities.

A5.28 Inclusive growth means that each area of Scotland is included in the growth of the Scottish economy. Some of the most visible examples of inequality are in the differences in economic performance in the different areas of Scotland. Areas such as Aberdeenshire and Edinburgh have significantly higher level of GVA per head than parts of Ayrshire and Dunbartonshire.

Figure 5.5 - Scottish Regional GVA (2014) and GVA Growth between 2010 and 2014



A5.29 Many of the areas of Scotland with the lowest GVA growth in this period also had a lower than average starting point for GVA per head. The areas with the four lowest growth rates

also have a GVA of less than the national average. This implies they are falling further and further behind. Regions with above average GVA in Scotland were more likely to have above average growth rates as well, similarly, those with lower than average GVA per head are more likely to have experienced lower than average growth rates. Therefore, the regional economic inequalities are growing as economies grow more slowly.

Localised Inequality

A5.30 Localised inequality also needs to be addressed. Even during times of economic growth and high employment, there are some areas where labour market participation has remained stubbornly low. Statistics on deprivation in Scotland[47] show that the most deprived 2-3% of localities in Scotland have more than a third of the working age population defined as employment deprived (which includes those on unemployment benefits and on incapacity and disability benefits) compared with a median of 10% (i.e. the absence of employment effects more than three times the people in the most deprived areas compared with what is typical).

A5.31 Improvements to the economy in general are not going to address this issue, which will require long term effort to address the multiple barriers to participation faced by too many people in these communities, in some cases over several generations.

A5.32 Organisations like the Princes Trust and local social economy organisations are already involved in this area and the central lesson that can be learned from their work is that it is localised action that is designed to meet the needs of individuals that is most effective, rather than national schemes. However, what is required at the national level is a commitment to fund such programmes over the long term, beyond the political cycle. This require both cross-party consensus on the need and value of such investment and mechanisms that can provide such funding (we return to this in Part B of the report).

Policy Analysis

A5.33 There is a significant role for Government in reducing inequality and therefore strategic policies are required to get Scotland from where it is to today to where it wants to be. There is no simple solution to the multifaceted nature of inequality however. The OECD has identified eight strategic policies that are likely to reduce income inequality. These are:

- improving the quality and reach of education;
- promoting equity in education;
- reducing the gap between employment protection on temporary and permanent work;
- increasing spending on active labour market policies;

[47] Scottish Government (2016), Scottish Index of Multiple Deprivation

- promoting the integration of immigrants;
- improving labour market outcomes of women;
- fighting discrimination; and
- taxing in a way that allows equitable growth.

A5.34 The current Scottish Government's economic strategy has the two mutually supportive goals of increasing competitiveness and tackling inequality. To achieve this, it sets out the four key priorities of investment, innovation, internationalisation and inclusive growth. The strategy incorporates the thinking of the IMF, OECD and others described above, that more cohesive economies improve the opportunities, life chances and wellbeing of every citizen. This would not only improve outcomes for individuals and households but be a critical driver of economic performance over the long term.

A5.35 Any Scottish Government with inclusive growth at its core will need to ensure that the policies that are implemented contribute towards this goal. The framework for assessing the future activities of national government in different policy areas may include:

- Fiscal Policy
  - Are the tax policies designed in a way that allows equitable growth?
  - Can we demonstrate how current fiscal policies will deliver increased prosperity and widening participation, but not inequality?
- Industrial Strategy
  - Does it encourage the creation of a range of accessible and flexible job opportunities?
  - Does it reflect the regional inequalities within Scotland?
- Social Security
  - Does it promote active labour market policies that encourage pragmatic early return to work?
  - Does it provide a safety net with a dignified minimum standard of living for all?
- Economic Participation and Fair Work
  - Do these measures help to reduce the gap between employment protection on temporary and permanent work?
  - Do they promote the integration of immigrants and improve labour market outcomes for women?

  - Do they help to remove barriers to labour force participation and fight discrimination?

- Education and Skills
  - Are these policies designed to improve the quality, reach and relevance of education?
  - Do they promote equity within the education system?
- Community engagement
  - Do the current arrangements enable local communities to identify and tackle issues concerning participation, health and wellbeing?

A5.36 Inequality in Scotland is multifaceted and the persistence of such inequality is detrimental to economic growth and social cohesion. As the policy areas listed above make clear a multi-faceted policy response is required, covering both policy areas current reserved to Westminster and devolved policy, as an integrated, comprehensive strategy.

A5.37 The prevailing thought among leading economists and international economic organisations is that inequality is harmful for the economy by reducing educational incentives, deprioritising investment and public services designed to increase growth, and by enhancing political uncertainty.

A5.38 Inequality in Scotland is evident in terms of gender, income and region. Some measures of gender and income inequality have seen slow improvements over the past two decades. However there is also evidence to suggest that regional inequality is getting more pronounced. The gains from tackling inequality are significant, for example reducing the gender pay gap to be equivalent to that in New Zealand could add £6.1 billion GDP to the Scottish economy.

A5.39 The policies and priorities of the Scottish Government have the potential to reduce the level of inequality in Scotland. Including inclusive growth as one of the four key priorities of the Economic Strategy is a positive step, however more needs to be done to ensure that the multifaceted nature of inequality is addressed across the policy spectrum.

A5.40 The fiscal benefits to successfully tackling the different areas of inequality are significant. The public-sector costs from poverty in Scotland are equivalent to £6.4 billion, therefore reductions in the incidence of poverty could save the Government billions. Reducing the gender pay gap could have a net exchequer impact of around £2.5 billion if the gap was closed to the level of New Zealand and all other factors remained equal.

A5.41 Where long term action is required to deliver benefits that will not be realised for a long time, it can be difficult to secure the scale of investment that is required. The proposals for a Fund for Future Generations set out in part B will be a new source of funding that could be used to target the generational challenges that have constrained the Scottish economy.

A policy challenge should therefore commence on identifying the best programmes to fund with such risk bearing capital for the long term. A competitive approach for funding against identified criteria and overseen by a cross and non-partisan governance structure may assist in securing the long term strategic approach that is required. In Part B, a mechanism for delivering this is discussed.

Participation and Labour Markets

A5.42 The lessons that can be learned from small advanced economies include the observation that they tend to move quickly to address economic threats and pursue opportunities. This has implications for how labour markets should work, to balance the needs of competitiveness in the global economy and security for those in employment.

A5.43 Lessons can be learned from Denmark's 'flexicurity' model, which has achieved political consensus and is accepted by employers, employees and trade unions. There are three main elements to the model: (i) flexible labour market rules for recruitment and dismissal, (ii) the availability of high levels of unemployment benefit, and (iii) active employment policies to ensure everyone has access to employment offers or education. It does not imply a diminution of employee rights and protections and it is notable that Denmark has one of the lowest rates of job insecurity[48].

A5.44 This model has delivered a competitive economy, high wages, very low youth unemployment and low structural unemployment in the Scandinavian economies. Employees change jobs regularly, with one-third changing jobs each year and growing sectors of the economy can secure the labour required to deliver growth. The high job turnover is also associated with high productivity since it has facilitated the transfer of skills and know-how between sectors.

A5.45 The shift to such a system over time could have substantial economic and social benefits. Such an approach would require close collaboration between government, employers representatives and trade unions to design a system that will work in Scotland and ensure that each of the related elements are implemented together. This is a good example of the more collaborative approach to policy design and implementation recommended in this report.

Key recommendations

A5.46 **A Commission on Gender Pay Equality** should be created with a remit to consult and engage across the economy and consider the best policies and incentives to produce a purposeful reduction in the gap with the performance of the best performing small advanced economies, especially New Zealand.

[48] OCED (March 2017), Labour market insecurity in OECD countries

A5.47 **The JRF target of a 50% reduction of poverty to 10%** of the population should be agreed within a stretching but achievable time frame. This policy should be elevated to central strategic importance in the overall strategy and prioritised accordingly in resource allocation.

A5.48 **Long term strategy on participation and inclusion**: agreement should be sought on the central importance of participation and inclusion to sustainable economic growth and a framework set up to oversee long term policy intervention and resource allocation from e.g. The Fund for Future Generations. Whilst inclusive growth is already a policy priority of the Scottish Government, the full powers of independence will provide an opportunity to expand the priority across all policy areas that can contribute, including fiscal policy, industrial strategy, social security, economic participation and fair work, education and skills and community engagement. **Strategic communication on the costs of inequality** should be a priority of government and political strategies. It is important to build a wider public understanding of the realities of the short and long-term costs so that agreement and support can be obtained for longer term interventions.

A5.49 **Labour markets and flexicurity**: Scotland can learn from Denmark and move to a flexicurity model, with flexible labour markets but without the insecurity the UK benefits system promotes. This would be expected to deliver lower unemployment, particularly lower youth unemployment and enhance productivity by stabilising investment incentives. We recommend a consultation of how a move can be made to establish a Scottish flexicurity model.

A6 PRODUCTIVITY & COMPETITIVENESS STRATEGY

- Increasing productivity growth in the Scottish economy will be crucial and will generate significant economic and social returns.
- There is a widespread view that current economic development arrangements are not adaptable enough to respond quickly to new opportunities for the Scottish economy. Brexit is forecast to worsen productivity.
- All of the approaches to increasing productivity growth require an increase in levels of investment in the Scottish economy, on improved technology, increasing capital intensity, better working practices and policies that encourage the growth of high productivity sectors.
- International competitiveness rankings matter and should be elevated in policymaking, target setting and debate. Agreement should be sought on how Scotland can best achieve the required improvements in relative production costs and prices. One way is through trade and international ownership because that makes domestic output subject to competition on the world markets (instead of just the domestic markets).
- An increase in trade share of GDP equivalent to 1% of GDP can increase productivity in the economy by 0.4%. More specifically, the benefits to labour productivity and how that feeds through to wages are estimated to be 2-3 times as big.
- Access to international markets is essential. The ability to integrate with international supply chains is critical for competitiveness and to attract foreign investment. The discipline of international competition can also help to drive innovation and new ways of working
- While there are many successful Scottish exporters, Scottish exports are more dependent on a small number of sectors that employ relatively few people.
- The potential Brexit damage to trade relations with Europe – and the risks to trade relations with other countries – means that Scottish dependence on the UK market is likely to grow after Brexit if Scotland remains part of the UK. This narrowing of Scotland's potential markets will be to Scotland's material economic disadvantage. That this is seen by some as a case for maintaining the current model strikes us as demonstrating a remarkable lack of concern and ambition.
- Maximising frictionless trade and market access with the rest of the UK and with Europe is of critical importance to the performance of the Scottish economy in the short and long term.
- Increasing overseas exports from 20% of GDP to 40% of GDP would be a reasonable target to set in order to close the export gap with small advanced economy benchmark countries, implying an increase from under £30 billion to more than £60 billion. This could deliver a productivity boost of 8% of GDP and would be expected to generate additional taxation revenues of some £5 billion each year.

- In Scotland, as in most other small advanced economies, improvements in productivity will come in myriad small advances, but a few major reforms would make that process a great deal easier – for example finding ways to encourage capital (total factor) productivity and repair the long standing investment rate deficit.
- Establishing a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful, in particular ways in which policies can be used to bring these opportunities to reality in practice. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model.
- The Anholt-GfK Roper Nation Brands Index examines the image of 50 nations. Scotland's score (61.8) and rank (17th) on the index show that Scotland already has a strong national brand. Across all dimensions, with the exception of exports, Scotland is ranked within the Top 20 countries indicating that there is room for improvement in the exports dimension.
- Digitalisation will continue have an immense impact on the world economy in the coming decades, offering potential in every sector. The digital sector has grown markedly over the past five years and must continue to be a priority growth sector for Scotland, given its potential long-term significance to the wider economy and also to the ability it provides to widen participation and globalisation in a country of Scotland's geographic position and structure.
- Higher Education Research & Development (R&D) significantly outpaces the UK and EU averages and lags only Denmark, Switzerland and Sweden. Scotland's university sector is a key comparative advantage for any growth strategy. Internationally Scotland's scientific outputs Scotland ranks top, and second to the Netherlands in terms of their influence. However, business R&D investment lags significantly behind EU, OECD and UK averages for both the government investment and business sectors. Improving this measure in key to overall productivity growth, higher investment, and strengthening the competitiveness in the Scottish economy.
- Even within countries and industries there can be large gaps between the most productive and others. The diffusion of knowledge is as important as pushing the boundaries of knowledge. Changes in technology resulting from science and innovation accounted for one-third of productivity growth that took place in the UK between 2000 and 2008.
- There is a leading role for the state in the promotion of R&D and innovation. Building on the Scottish Government's Can Do Innovation Forum, additional initiatives are required to improve commercialisation performance and enhance the role of workplace skills in innovation and the creation of a learning economy.
- Infrastructure is critically important and can deliver significant economic returns on investment. The UK (and Scotland) significantly underperform. The World Economic Forum's Global Competitiveness Index ranked the UK only 28th in the world on quality of infrastructure. An Infrastructure Commission is urgently required along with a longer-term commitment to increased investment.

A6.1 The need to increase productivity growth and competitiveness in the Scottish economy is an issue that has been recognised for some time. Over recent years as demonstrated in Chapter A1, Scotland has performed respectably well compared to the UK, but only in the past decade and only in labour productivity. That said the UK overall has a deep-seated problem. But it would be wrong to simply dismiss UK performance and say that Scotland can immediately emulate others more quickly, this has proven the single most difficult economic policy nut to crack for decades and involves a raft of other factors. Moreover the UK record also involves trade-offs against other policy objectives such as the reduction of mass unemployment from the 1980s which means the UK record on productivity is mirrored by relatively low unemployment now; in contrast to say France which has higher productivity in some sectors, low in others, but less flexible markets and hence higher unemployment.

A6.2 However, a number of institutional approaches to economic development have been designed to help boost productivity in the economy. These include:

- Securing foreign direct investment, based on extensive and effective marketing of Scotland in investor markets, initially in manufacturing (with 'Silicon Glen' being the most obvious example) and more recently in R&D intensive businesses;
- Efforts to promote entrepreneurship and assist business start-ups to boost the business birth-rate in Scotland, which had lagged many comparator economies, particularly in more industrial areas where large employers had dominated the economy;
- Area-focused physical regeneration to improve the attractiveness of place to people and potential investors;
- Initiatives to increase the economic impact of publicly funded research by increasing the commercialisation of research undertaken in universities and research institutes (for example, by supporting spin-out companies);
- Providing intensive public-sector support to new and young companies thought to have high growth potential;
- Cluster based strategies that have targeted companies and their supply chains in sectors and markets with growth potential where Scotland has existing or potential competitive advantage.

A6.3 The Scottish Government has recently undertaken a review of the economic development and skills agencies and how they interact. The aim of that review has been to ensure that businesses, the workforce, training providers, colleges and universities and young people receive the joined-up support they need.

A6.4 During the engagement process undertaken by the Commission it was clear that the arrangements for economic development support need to be adaptable enough to respond quickly to new opportunities for the Scottish economy – or indeed to threats, such

as that presented by Brexit. Scottish Government analysis[49] estimates that 60% of the negative economic impacts of Brexit on the Scottish economy by 2030 would be associated with restrained productivity growth.

A6.5 While policy evaluations have demonstrated good value for money in public investment, there remains a gap between productivity in the Scottish economy and in the best performing small advanced economies. This alone should be a reason for fresh thinking on the approach taken to economic development in Scotland.

A6.6 There has generally been an assumption in economic policy, particularly macroeconomic policy, that there is a limit on productivity growth and that it is challenging to exceed the long-term trend rates. Below trend productivity growth in most advanced economies since the crisis has even led some (such as American economist Robert Gordon) to argue that economic growth will be slower in the future.

A6.7 However, others, who have looked at the productivity issue from the perspective of companies and individuals have been far more optimist about the potential to accelerate productivity growth. For example, analysis by Joseph Stiglitz shows that if each business was to target best practice in all aspects of business in the industry they are part of, the potential for productivity growth would be enormous[50]. This requires a greater focus on learning by doing, to create a learning economy and a learning society.

A6.8 There is also an important role for industry groups to build stronger networks and to bring businesses together to tackle issues of common interest where collaboration might deliver more than competition. The new Strategic Board overseeing the economic development agencies should consider how the current structures might assist industry groups in this role and how the agencies can respond rapidly to economic opportunities and threats, such as Brexit.

A6.9 We also recommend that a fixed term Productivity Commission is established to identify opportunities for productivity improvement. Whilst not wishing to prejudice the outcome of such a process, there are a number of areas that we can be confident will be important and where action should be taken now. They are set out in the remainder of this chapter, and include:

- Global competitiveness standards;
- Trade and market access;
- Digital infrastructure and skills;

[49] Scottish Government (January 2018), Scotland's Place in Europe: People Jobs and Investment
[50] Stiglitz and Greenwald (2014), Creating A Learning Society – A New Approach to Growth, Development and Social Progress

- Science and innovation;
- Work based skills and learning; and
- Infrastructure.

Global Competitiveness Standards

A Competitive Location

A6.10 There are many rankings that are used by international organisations to measure the comparative advantages of doing business by country. These indices aim to highlight some of the key strengths and weaknesses of economies, so policy makers and investors can react accordingly. In doing so, all indicators aim to quantify, not just the current prospectus for economic development but also the economic development potential for the future.

A6.11 This section considers some of the methods used to undertake such analysis and the countries that perform well in a range of indices. In order to reflect the wide spectrum of ranking indicators, three indices are used in this analysis, which all take different approaches to the measure of competitiveness. The rankings that are considered in this section are:

- Global Competitiveness Report (World Economic Forum)
- Global Sustainable Competitiveness Index (Solability); and
- The Venture Capital and Private Equity Country Attractiveness Index (IESE, University of Navarra)

Global Competitiveness Report

A6.12 The Global Competitiveness Report [51], produced by the World Economic Forum is, one of the most highly respected global rankings of competitiveness. It considers 12 key pillars that contribute to the overall all score of competitiveness of a country. These metrics range from purely economic to more social orientated indicators. The 12 key pillars are:

- Institutions;
- Infrastructure;
- Macroeconomic Environment;
- Health and primary education;
- Higher education & training;

[51] World Economic Forum (2016), The Global Competitiveness Report 2016 - 2017

- Goods market efficiency;
- Labour market efficiency;
- Financial market development;
- Technological Readiness;
- Market size;
- Business sophistication; and
- Innovation.

A6.13 Table 6-1 shows what each of these pillars measures and the stage of economic development that each would represent. The pillars required for even a basic economy to function, such as Institutions and Infrastructure, are measured to enable comparisons with less developed factor economies. The economies that are highly developed, such as those with the highest rankings, primarily compete over the Business Sophistication and Innovation indicators.

Figure 6.1 - Global Competitiveness Report Metric

Source: World Economic Forum

A6.14 In these rankings, tax rates do play a role in contributing to the overall competitiveness of an economy. In particular, the effect of taxation on incentives to invest, which forms part of the 'Goods Market Efficiency' indicator, and the effect of taxation on incentives to work, which forms part of the labour market efficiency indicator. The complexity of the taxation system can also be one of the problematic factors identified for doing business.

A6.15 The top position in the rankings has been held by Switzerland for the past seven years. This is a result of high level of investment in private sector research and development, research institutions, infrastructure and connectivity. Switzerland also leads the world in labour market efficiency and labour/employer collaboration. However, there are potential risks to Switzerland's competitiveness and position in the rankings that were highlighted in the analysis. In particular, in 2014 there was a referendum in which the electorate narrowly voted to reduce the level of immigration into the country. The World Economic Forum identifies openness to international talent as a positive driver of growth and therefore the lack of policy certainty regarding immigration may harm Switzerland's ability to benefit from the global talent pool that drives its economy.

Table 6-1: Global Competitiveness Report Rankings

Country	Rank	Score
Switzerland	1	5.81
Singapore	2	5.72
United States	3	5.70
Netherlands	4	5.57
Germany	5	5.57
Sweden	6	5.53
United Kingdom[52]	7	5.49
Japan	8	5.48
Hong Kong SAR	9	5.48
Finland	10	5.44

Source: The Global Competitiveness Index 2016 - 2017

A6.16 The countries ranked in the top ten represent a number of different approaches to economic strategy. This includes countries such as Finland and Sweden, where government spending is equivalent to over 50% of GDP, and Switzerland where Government expenditure is equivalent to one third of GDP[53]. Additionally, some countries, such as Singapore and Hong Kong have the highest trade to GDP ratios in the world, while Japan and the USA are among the lowest. The comprehensive scope of the metrics

[52] The measures for the UK were taken prior to the vote to leave the EU and the WEF notes that this decision is likely to have implications for the future competitiveness of the UK.
[53] OECD (2015) Government at a Glance 2015

involved in the Global Competitiveness Ranking mean that there is no single approach to economic strategy that has authority of others.

Global Sustainable Competitiveness Report

A6.17 There are other rankings of international competitiveness that take slightly different metrics into account in order to reflect different priorities. This includes the Global Sustainable Competitiveness Index (GSCI), which is collated by SolAbility Sustainable Intelligence[54]. The GSCI considers the ability for countries to sustain wealth creation and therefore considers a wider range of metrics that not only cover how competitive they are currently, but also how their actions and priorities will impact on their ability to maintain this level of attractiveness in the future.

A6.18 The GSCI acknowledges that the WEF rankings are most widely respected, however it highlights that much of the data is taken from surveys of business leaders, rather than from empirical data. Therefore, there is greater emphasis on measurable and available metrics in the GSCI analysis to avoid any issues with perception and selection that arise from survey analysis. The metrics used in this analysis cover five main pillars of sustainable competitiveness, namely:

- Natural Capital;
- Governance;
- Intellectual Capital;
- Resource management; and
- Social Capital

A6.19 Unlike other measures of international competitiveness, the GSCI does not include the level of personal or corporate taxation as one of the metrics in its analysis. Instead this analysis considers the implications for the output of public spending rather than the costs associated. For example, the GSCI includes measures on the quality of education, quality of healthcare and environmental protections.

A6.20 The countries that are highest ranked in the GSCI are all in Europe and the top five of these are all Scandinavian. These countries have abundant natural capital and strong socially democratic societies that excel in many of the metric that are used to calculate the GSCI score.

[54] SolAbility (2016) The Sustainable Competitiveness Report, 5th Edition

Table 6-2: Global Sustainable Competitiveness Rankings

Country	Rank	Score
Sweden	1	60.9
Norway	2	59.4
Finland	3	56.2
Denmark	4	56.0
Iceland	5	56.0
Slovenia	6	54.8
Switzerland	7	54.4
Ireland	8	53.9
Luxembourg	9	53.8
Austria	10	53.8

Source: The Global Sustainable Competitiveness Index 2016

The Venture Capital and Private Equity Country Attractiveness Index

A6.21 The Venture Capital and Private Equity Country Attractiveness Index (VC/PE-I)[55] is designed to give venture capitalists and private equity investors a quick overview as to the comparative strengths of different countries as a destination for investment. There is a stronger emphasis on the operation of the financial markets in this index than in the other competitiveness measures. It also includes the overall size of the economy as a metric, to reflect the size of the domestic market that the investment would enter.

A6.22 The key metric pillars in this system are:

- Economic Activity;
- Depth of Capital market;
- Taxation;
- Investor Protection & Corporate Governance;
- Human & Social Capital; and
- Entrepreneurial Culture & Deal Opportunities.

A6.23 As with the GSCI, the VC/PE-I is based on quantified data from other surveys and analysis, rather than the results of surveys. This enables the inputs to be more objective, compared to responses from individual surveys.

[55] Groh et al (2016), The Venture Capital and Private Equity Country Attractiveness Index: 2016 Annual

A6.24 The index is topped by the United States, followed by the UK. The North American countries perform particularly well with the pillars of 'Economic activity', 'Depth of Capital Market' and 'Entrepreneurial Culture and deal opportunities'. However, they are outscored by Western Europe and Australasia for measures related to taxation.

Table 6-3: VC/PE-I Attractiveness Rankings

Country	Rank	Score
United States	1	100.0
United Kingdom	2	95.5
Canada	3	94.3
Singapore	4	93.3
Hong Kong	5	92.7
Australia	6	91.9
Japan	7	91.8
New Zealand	8	88.7
Germany	9	88.6
Switzerland	10	85.7

Source: The Venture Capital and Private Equity Country Attractiveness Index 2016

Increasing Scotland's Competitiveness Rankings

A6.25 The international competitiveness rankings and how countries are perceived as places to do business are dependent on a wide variety of metrics used and the lens through which the analysis is undertaken. The three indices of competitiveness that are presented in this section are by no means exhaustive, however they do represent a variety of stances that can be taken. In all ranking methodologies, although taxation plays a role in how competitive countries are perceived, it is the wider suite of complimentary attributes that create a competitive business culture. Switzerland is the only country that appears in the top ten of all three rankings.

A6.26 The Government of an independent Scotland would need to focus on different policy priorities in order to be considered a competitive location by the different indices. Policies that made Scotland more open to talent and trade would support a higher ranking in the WEF's Global Competitiveness Report, particularly as these factors also contribute to the ability of an economy to innovate which is the main area of competition for highly developed economies. These are all factors that the WEF notes will be adversely affected by the UK's decision to leave the single market, therefore policies to retain Scotland's membership of the single market would likely improve its competitiveness ranking in this index.

A6.27 An independent Scottish Government would need to pursue different policy priorities in order to be considered competitive by the GSCI and VC/PE-I. Policies aimed at the long-term cultivation of natural and human resources will result in higher ranking in the GSCI, while policies that protect business interests and financial markets would see a higher ranking in the VC/PE-I. Excelling in both indices may require seemingly contradictory priorities, however as has been shown by Switzerland, success in either does not need to be mutually exclusive.

Engagement of International Companies and Sectors

A6.28 The period of uncertainty with Brexit and its implications and any period leading into or following a potential independence transition should be marked by senior and open dialogue to help organisations achieve opportunities, mitigate risk and regard Scotland as a country with whom it is extremely easy to do business and obtain quick decisions and relevant support.

A6.29 The Scottish Government's capacity in this regard should be critically assessed and the recruitment considered of senior sector facing Ambassadors ideally drawn from the very top of business leadership with a public service motivation and an operation that seeks to be world class in support. Such an approach can build on and utilise the existing Global Scot network. Clear priorities for engagement in this way include: Financial Services, Science, Innovation & Technology, Construction Infrastructure and Property, Energy, Engineering, and Life Sciences. But the range will require detailed consideration.

Smarter Taxes

A6.30 Section B of this report recommends a review of the tax system beyond the current tax powers held by the Scottish Parliament. One of the principles behind the review recommended is that the system should explicitly support the overall economic strategy, which must include a focus on boosting productivity.

A6.31 Investors and entrepreneurs alike can often face barriers and inequities in the UK tax system. The system needs alignment with the needs of the modern economy. As an example, a measure that could be taken to the advantage of the wider economy, and investors and entrepreneurs whether domestically grown or coming to Scotland as new Scots, could be the following.

A6.32 The UK tax system favours debt, giving tax deductibility for interest on debt. But this has created an uneven playing field for equity investment and creates an incentive to have highly geared businesses. There is a case therefore for considering the introduction of a targeted tax allowance or deduction for equity investment based on a cost of capital calculation. This would be attractive to Scottish family owned businesses that have a higher aversion to debt, and at the same time give more encouragement to equity financing models for new businesses and entrepreneurs, including in hi-tech sectors which are

sometimes considered to be high risk investments by equity funders. It will add a richness to the business investing scene that will assist in underpinning growth.

A6.33 In other words, there are going to be many opportunities for Scotland to incentivise economic growth. Such incentivisation will come from a range of cultural, social, political and economic choices, taken in the interests of the Scottish economy and Scottish people. What must be improved upon is simply mirroring any UK policy that dis-incentivises growth. Small advanced economy benchmarks matter.

Trade and Market Access

A6.34 The route to better, higher-paid jobs is productivity growth. That requires innovation in products and in the way businesses work, as well as investment in people and in new technology.

A6.35 The productivity benefits from trade are substantial. On the balance of evidence available, an increase in trade equivalent to 1% of GDP can increase productivity in the economy by 0.4%. More specifically, the benefits to labour productivity and how that feeds through to wages are estimated as 2-3 times this effect.

A6.36 On this basis, in the context of Scotland's economy, each 1% of GDP increase in trade would be expected to increase GDP by around £600 million and generate additional tax revenues of around £230 million. Becoming an independent country will clearly mean Scotland becoming a more outward looking nation, taking part in various international organisations. Access to international markets is essential. The ability to integrate with international supply chains is critical for competitiveness and to attract foreign investment. The discipline of international competition can also help to drive innovation and new ways of working.

A6.37 While there are many successful Scottish exporters, Scottish exports are more dependent on a small number of sectors that employ relatively few people. There is therefore an enormous opportunity for economic growth based on exporting expansion.

A6.38 Scotland and the rest of the UK have a mutual interest in maintaining a close trade and investment relationship as this benefits both. But if the Scottish economy is to realise its full potential, then we must build stronger direct trade and investment links with other European countries and the rest of the world.

A6.39 Independence and membership of the EU Single Market would create new opportunities for businesses in Scotland to do just that. It would allow Scotland to maintain and further develop the access that is needed to international markets, in the EU and beyond. It would allow a Scottish Government to work at home and in Europe to ensure the right policy framework exists for business and to improve the competitiveness of the Scottish economy. And it would position Scotland as a bridge between Europe and the rest of the UK at a time when many businesses are looking for just that.

A6.40 Consideration of the optimal approach to Brexit is a priority for the Scottish Government at present. Our view is that maximising frictionless trade and market access with the rest of the UK and with Europe is of critical importance to the performance of the Scottish economy in the short and long term. The damage that could be done to the Scottish economy of not achieving such an outcome has been set out in Scotland's Place in Europe: People, Jobs and Investment, published by the Scottish Government in early 2018.

Scotland's Export Performance

A6.41 An analysis of Scotland's export statistics[56] shows that:

- Scotland's overseas onshore exports were valued at £29.8 billion in 2016, 20% of GDP;
- including the rest of the UK increases Scottish exports to £75.6 billion in 2016; and
- including the most recent data available on oil and gas trade flows (from 2014) would increase exports to more than £90 billion.

A6.42 The high proportion of Scottish exports going to the rest of the UK (61%, excluding oil and gas) should not be surprising since countries typically trade far more with near neighbours who share the same language, land border, single market and have longstanding economic ties. For example, more than three quarters of Canadian exports go to the United States.

A6.43 Scottish exports have been increasing, up by more than 20% since 2010 but are still behind international comparators.

A6.44 Over the last decade or two, there have been changes in the nature of Scottish exports, both overseas and to the rest of the UK. There has been little overall growth in manufacturing exports, with the growth in food and drink exports compensating for the reduction in electronics exports. Service exports have becoming increasingly important.

A6.45 Including oil and gas exports would mean that Scotland's exports were above average for advanced economies. However, in planning for the long-term it would make sense to treat oil and gas exports as a bonus and to concentrate on a target for exports, excluding oil and gas.

A6.46 There are gaps in the data that are available on Scotland's trade balance, and on the wider balance of payments position, and these should be addressed so that the evidence is available on which decisions on policy and assessments of its success can be based.

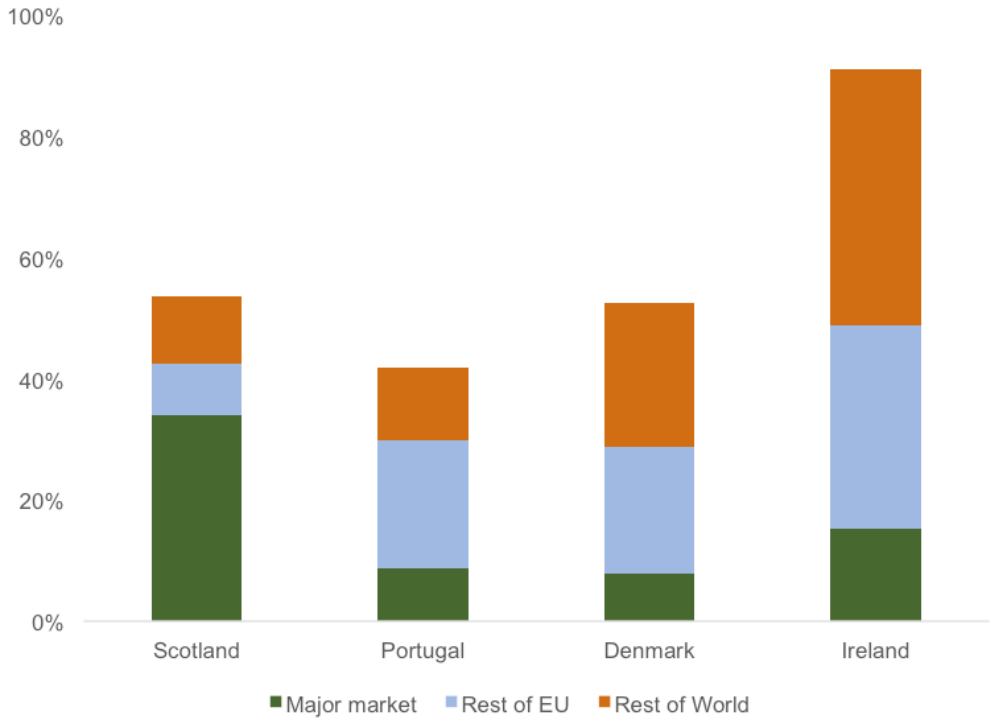
A6.47 If trade with the rest of the UK is included in the analysis, then the Scottish export position benchmarks well with other small advanced economies. However, there is no intrinsic economic reason why Scottish business should be less open to the world than firms in the rest of the UK. If Scotland matched the rest of the UK in overseas exports, this would

[56] Scottish Government (January 2018), Export Statistics Scotland 2016

increase exports by £12 billion, more than 8% of GDP. This both demonstrates the over dependent on an unbalanced UK economy that is growing more slowly over the long term than the global economy and shows the scale of the opportunity.

A6.48 Comparing Scottish exports with other European economies, illustrates the opportunity. Figure 6.2 shows how Scottish exports compare to Portuguese, Danish and Irish exports. These countries are a similar size to Scotland and they each have a large neighbour that is a major export destination – Spain in the case of Portugal, Germany for Denmark, and the UK for Ireland. Figure 6.2 shows that Scotland is much more dependent on its big neighbour than any of these other countries. Scotland's dependence on its big neighbour looks excessive when compared to these countries.

Figure 6.2 - Scottish exports compared with other countries, per cent of GDP



Source: ONS, Scottish Government, Eurostat, CSO, Statbank, Pordata

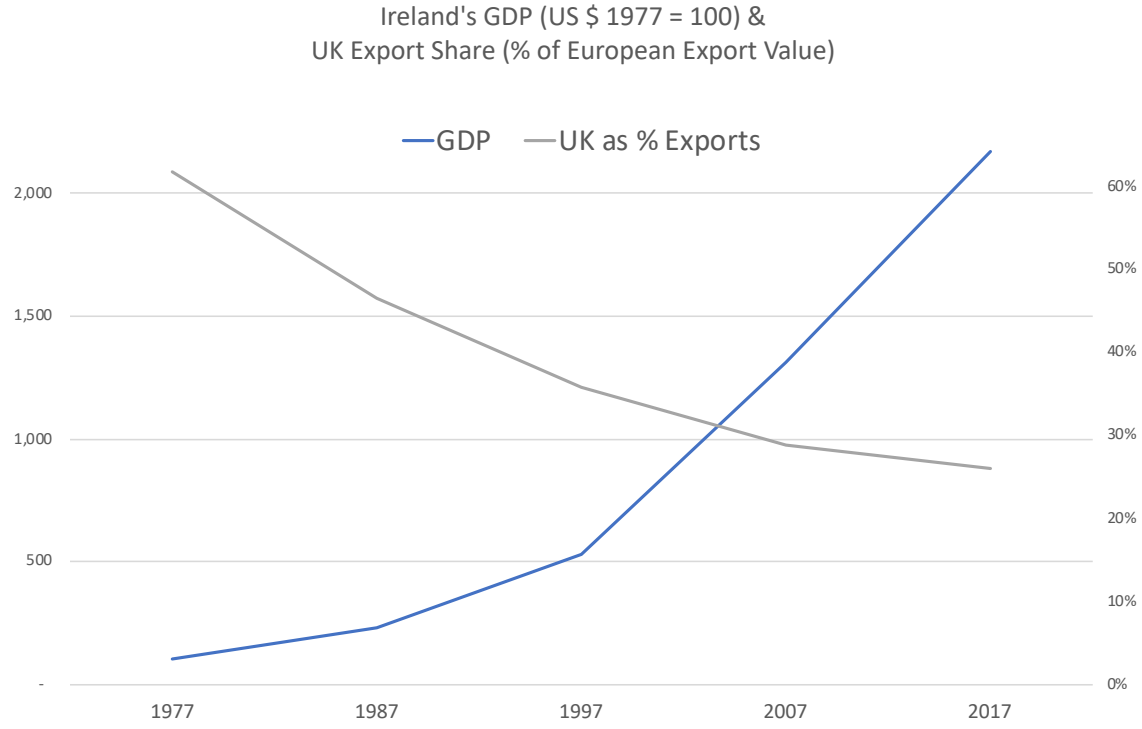
A6.49 Scotland also looks to have untapped potential when it comes to exporting to the rest of Europe and beyond also looks weak in comparison. Ireland exports 33.6 per cent of GDP to the rest of the EU (excluding the UK) compared to 8.4 per cent for Scotland. Ireland exports 42.1 per cent of GDP to the rest of the world, compared to 11.2 per cent for Scotland.

A6.50 For Scotland, whisky alone accounts for about a quarter of Scottish goods exports. While the sector is undoubtedly an export success story, it directly employs just 10,800 people.

A6.51 The UK market is clearly important for the Scottish economy and will remain so regardless of Scotland's constitutional future. But the record of other countries demonstrates the scale of international opportunities.

A6.52 Ireland's example of export and economic growth is particularly instructive (Figure 6.3). Between 1977 and 2017, Irish exports grew significantly, driving overall economic growth. Access to European as well as UK markets, meant that Irish exports to the UK continued to grow significantly but there was much more rapid growth in exports to the rest of Europe, meaning that Ireland's exports to the UK were 62% in 1977 and 26% in 2017.

Figure 6.3 – Trends in Irish Economic Growth and Dependence on UK Exports



Source: CSO and OECD

A6.53 Even a much more modest export growth target than that achieved by Ireland would deliver significant impacts. Increasing overseas exports from 20% of GDP to 40% of GDP would be a reasonable target to set, when set in context of other small advanced economies. This implies an increase from under £30 billion to more than £60 billion.

A6.54 As well as the direct impacts on economic performance, such an increase would also be expected to boost productivity in the economy. Given that 0.4% productivity growth is associated with each 1% of GDP increase in exports, such an increase in exports could deliver a productivity boost of 8% of GDP (£12 billion in current terms) and this would be expected to generate additional taxation revenues of some £5 billion each year.

The risks from Brexit

A6.55 Brexit means that future access to the EU market is now uncertain. The UK Government has said that it wants to leave the single market, leave the EU customs union and end the free movement of EU citizens in the UK. Instead, the UK Government wants to base the future economic relationship with the EU on a free trade agreement. Negotiating the withdrawal from the EU and the future relationship will be difficult. The outcome is uncertain, creating risks for business.

A6.56 The EU has made clear that there can be no better relationship with the EU than from membership of the EU. Leaving the regulatory perimeter of the EU and shedding the obligations of membership, such as free movement of people, must come at a price in the ease of access to the single market. The European Commission has set out the options facing the UK if the UK Government insists on sticking to its red-lines. These amount to a "Canada- style" free trade agreement or reversion to WTO terms. Both will carry a heavy economic cost, with services in particular suffering. These costs have been set out in the Scottish Government publication: Scotland's Place in Europe: People, Jobs and Investment.

A6.57 In the services sector businesses are likely to lose some of their existing rights to trade (passporting) or invest across EU borders. They may find they become subject to the vagaries of national licensing regimes when the UK loses the protections provided by membership of the single market. In some sectors, such as financial services, companies may need to relocate some of their operations inside the EU if they are to continue serving EU customers.

A6.58 Access to EU markets is also a driver of foreign investment and so there is a risk to Scotland of both domestic and foreign investment.

A6.59 It will take many years before we know the full extent of the damage to the trade and investment relationship between the UK and the EU, because it will take many years before a new relationship is fully negotiated and implemented. But it is clear that the relationship will suffer, making it harder for Scottish businesses to internationalise.

A6.60 Brexit also creates risks for Scotland's trade relationship with the rest of the world. Scotland currently benefits from the trade deals the EU has with some 50 countries around the world, including South Korea, South Africa, Turkey, Switzerland and Mexico. The EU has recently concluded a trade deal with Canada and is close to concluding a deal with Japan.

A6.61 When the UK leaves the EU these trade agreements will no longer apply to the UK. The UK Government has said it wants to 'transition' existing EU agreements to UK agreements. This is unlikely to be straightforward. Some aspects of trade deals, such as import quotas, cannot be transposed and a deal that is attractive with the EU may look unbalanced when applied to the UK. This makes renegotiation inevitable. With goodwill that may be possible. But it is unlikely to be smooth and will take time. Legislative processes in other countries could

be slow and complicated, for example by requiring governments to consult widely before concluding a trade agreement.

A6.62 The damage to trade relations with Europe – and the risks to trade relations with other countries – means that Scottish dependence on the UK market is likely to grow after Brexit if Scotland remains part of the UK.

Access to Markets and Minimising Friction

A6.63 Scotland's economic interests will be best served maximising frictionless trade and ensuring access to UK, EU and wider global markets.

A6.64 An independent Scottish Government would be able to use the full range of economic policies to improve the openness of the Scottish economy and the competitiveness of Scottish business.

A6.65 These include financial sector policies, taxation, employment laws, foreign policy and immigration rules. These policies are currently controlled by the UK Government and in ways that often fail to address the needs and comparative advantages of the Scottish economy. For example, the increasingly restrictive British immigration policy is damaging the international competitiveness of the Scottish higher education sector.

A6.66 A Scottish Government with its own trade focussed diplomatic network, would be able to ensure that the full range of government assets, including diplomatic resources, are available in the export markets that matter most to Scottish business around the world.

A6.67 The Scottish Government would also be able to respond to the needs of potential foreign investors. The European countries that have been most successful in attracting inward investment are those whose governments understand the needs of investors and respond to them. This means aligning the full range of policy tools at the disposal of national and local government, including industrial, transport, fiscal and R&D policies.

A6.68 The UK Government would have a strong interest in maintaining a trading relationship with Scotland that is as open and frictionless as possible. Scotland is the 2nd biggest trading partner for the rest of the UK. In 2015 Scotland imported over £50 billion from the rest of the UK, which is more than the whole of the UK exports to any other country except the United States and over three times as much as the whole of the UK exported to China. The rest of the UK had a surplus in the trade relationship with Scotland of £5.2 billion in 2015.

A6.69 Brexit would mean that the trade relationship with an independent Scotland would change, but it would remain strong. It is wrong to suggest that Scotland would have to choose between the two markets. But to enjoy the best access to both markets Scotland must be positioned in the EU single market.

Export Based Growth Strategy

A6.70 The case for and main features of an export based growth strategy have been set out before, including in a report by N-56[57]. These recommendations remain valid and are set out here.

A6.71 Export growth is driven by competitiveness, of which productivity growth is a major component. Therefore, the best policies to promote export growth are those that enhance the productivity of exporters and potential exporters, such as investment in infrastructure, research and development and education. In addition, an exports-based growth strategy will require targeted fiscal policies in those sectors where Scotland has existing strengths and potential. Therefore, export growth should be more prominent in Scotland's economic strategy.

A6.72 The wide range of policies required to stimulate productivity growth can be seen in best practice strategies from elsewhere. For example, the Danish Globalisation Strategy consists of 350 policy measures under 14 areas of focus. As can be seen in Figure 6-4, 8 of the 14 areas of focus are concerned with education, three with research and innovation and one each with interaction with other countries, entrepreneurship and a collaborative approach to implementing the strategy.

[57] N-56 (February 2015), Export Based Growth – Global Competitive Advantage from the Scottish Brand

Figure 6-4 – Focus Areas in the Danish Government's Globalisation Strategy

World top performing primary and lower secondary school system
All young people should complete a general or vocational upper secondary education programme
A coherent education system and professional guidance
At least 50 per cent of young people should complete a higher education programme
Education and training programmes with a global perspective
World top level short-cycle and medium-cycle higher education programmes
World top level universities
More competition and better quality in public sector research
Good framework conditions for companies' research, development and innovation
Stronger competition and greater openness and transparency to strengthen innovation
Strong interaction with other countries and cultures
More high-growth start-ups
Everyone should engage in lifelong learning
Partnerships to promote the implementation of the Globalisation Strategy
Inclusive Growth: Growth that combines increased prosperity with greater equity; that creates opportunities for all and distributes the dividends of increased prosperity fairly points

Source: Danish Government, Progress Innovation and Cohesion, May 2006

A6.73 Learning from Denmark, education and innovation will be important elements of an export-based strategy for Scotland, building on existing strengths. However, the starting position for Scotland's new strategy is different from Denmark's globalisation strategy. For example, Scotland already has world leading universities and high levels of participation in higher and further education, although continued investment will be required to maintain this position as others seek to compete.

A6.74 Conversely, Scotland's infrastructure, including global connections for people and goods, has been held back by lower levels of investment than Denmark's and so requires greater attention. The opportunity associated with Scotland's geographic position to develop hub airport services and international freight ports would lower the barriers to export for Scottish businesses that are not currently exporting.

A6.75 While there may be a gap in trade levels between Scotland and competitor economies, there are some sectors of the economy that have achieved significant success in export markets and from which lessons can be learned. These include the whisky industry and more recently other food and drink such as salmon, as well energy services, precision measurement, digital industries, life sciences, education and tourism.

A6.76 A common feature of these sectors is that they rarely distinguish between domestic and export markets, seeing their markets as global. In the case of whisky, entrepreneurs such as Johnnie Walker travelled to sell his product in all markets to which ships sailed and in oil and gas, supply chain companies that grew in Scotland as the North Sea has grown have followed their customers to wherever there has been oil to discover and extract.

A6.77 These successes help to demonstrate the potential benefits from a cooperative approach to policy making as recommended by N-56, since such a process would involve inviting representatives from those sectors to share their experience with others.

A6.78 The policy package required to support an exports-based growth strategy will therefore require a number of elements, including:

- establish a Ministry for Trade and Foreign Affairs to oversee a new and heavily integrated approach to trade, investment and economic diplomacy;
- build a new embassy and consular network with economic diplomacy as its core purpose and with the ability to help harness and direct all of Scotland's international activity;
- retain the link between internationalisation and wider business support through the enterprise networks but with increasing emphasis on, and incentivisation of, growing the number of domestic firms engaged in exporting activity;
- establish a stronger, better funded inward investment agency with an independent and high level Board including representatives of indigenous and investor business communities;
- direct more resources to trade and internationalisation activities recognising that comparator countries spend more on supporting exports, attracting inward investment and promoting tourism than Scotland currently does; and
- provide financial support mechanisms for exporting businesses e.g. export credit guarantees that are at least as generous as those provided in comparator nations.

A6.79 This is a distinctive strategy for the Scottish economy; however, it would require divergence from the UK's economic strategy, with its high reliance on the financial services sector in the City of London.

A6.80 Scotland has global comparative advantage in a number of fast growing sectors. Scotland has a worldwide reputation for producing premium food and drink products. In 2016, exports of these products amounted to around £5.5 billion. Following the successful examples of whisky and, more recently, salmon, the food and drink sector also has the potential for export growth.

A6.81 Universities can continue to grow their competitiveness in the international education market, based on the reputation of Scottish education. Five Scottish universities rank

amongst the top 200 universities in the world, which means Scotland has the second highest number of top performing universities per capita.

A6.82 The tourism sector supports almost 181,500 jobs, contributes more than £3.0 billion to the Scottish economy each year and earns £1.2 billion in exports. Scotland's history and environment provides a competitive advantage in the tourism sector that is impossible for other countries to replicate.

A6.83 These and other sectors provide a large number of opportunities for the Scottish economy but Scotland cannot expect to be dominant in any of these global markets at the macro level. However, with globalisation a small country like Scotland can perform well economically by developing niche competitive advantages.

A6.84 A number of factors will play a role in supporting Scotland to achieve export growth. Expanding exports will be dependent on maintaining access to global markets. In addition, successful Scottish exporters have demonstrated the importance of sales and distribution networks. There may be potential to reach agreements for large companies to work with small and medium sized companies in export markets, as well as a role for government agencies to assist businesses to establish new distribution channels, particularly in emerging markets. This is an area that Germany excels at, government agencies and companies working collaboratively, pooling expertise and sharing costs, to create hubs in new markets, which help to build trust and confidence in these markets, and help to introduce new exporters to the established networks of more experienced exporters.

A6.85 Developing sales and distribution networks also requires the necessary skills to be available. Although English is increasingly the language of international business, businesses which do most to respect and understand the culture of the countries in which they operate, including language are likely to do better. An export-based growth strategy will therefore require that skills gaps in sales and languages are addressed.

A6.86 The development of a national brand can also assist businesses in export markets, since it provides a foundation on which they can build their own brand, if they choose to. The Anholt-GfK Roper Nation Brands Index examines the image of 50 nations. Scotland's score (61.8) and rank (17th) on the index show that Scotland already has a strong national brand. Across all dimensions, with the exception of exports, Scotland is ranked within the Top 20 countries indicating that there is room for improvement in the exports dimension.

A6.87 The small country case studies of New Zealand and other countries highlight the benefits of being able to invest behind a specific brand – and particularly one that is supported by a coherent policy approach. Other lessons that can be drawn from these case studies include the necessity of a realistic and authentic national brand. The focus therefore should be on generating outcomes, not simply investing in marketing or PR. This is important because the branding efforts need to be consistent and sustained and to be linked to policy settings. The development of a national brand for Scotland is an initiative that should be developed by collaboration between government and business. This is an area where

VisitScotland has developed expertise and so would be the obvious choice to lead this activity.

A6.88 In summary:

- export growth should be more prominent in Scotland's economic strategy, since it is associated with productivity growth and improved economic performance;
- continued access to global markets is critical;
- the potential to reach agreements for large companies to work with small and medium sized companies in export markets, as well as a role for government agencies to assist businesses to establish new distribution channels, particularly in emerging markets, should be explored;
- an export-based growth strategy will require that skills gaps in sales and languages are addressed; and
- a realistic and authentic national brand should be developed for Scotland, building on existing initiatives and learning from best practice elsewhere, particularly New Zealand. This is an initiative that should be developed by collaboration between government and business, perhaps led by VisitScotland.

A6.89 The investment in marketing and communications behind Scotland's reputation internationally is very significantly below that achieved by other countries including Benchmark small advanced economies. In 2015 Ireland invested £27 million, New Zealand £72.3 million and Norway (2014) £68 million compared to Scotland at c£6 million[58]. We recognise the recent progress made in this area, welcome the Scotland is Now initiative. While recognising all financial constraints it is clear that if a longer term invest and return perspective was analysed that an improvement in spend here would significantly enhance the economic and therefore exchequer returns.

Digital Opportunity

A6.90 A report produced by SCDI[59] concluded that the benefits of digital connectivity "must be transformational, not incremental" and recommended that Scotland should be a nation of "Digital Pioneers, Digital Champions and Enthusiastic Explorers".

A6.91 The report highlights the potential for digital technologies and digitally-enabled business models to boost productivity in the Scottish economy. However, it also notes that, while Scotland is developing a world-class digital infrastructure, this investment will only achieve its full worth through world-leading utilisation and that increasing Scotland's productivity

[58] Figures from VisitScotland research

[59] Scottish Council for Development and Industry (2016), Digital solutions to the productivity puzzle

will require leadership and action at a national level but also in all the businesses across the economy.

A6.92 The economic risks and opportunities include:

- Businesses: those that do not become fully digitally engaged are likely to fall victim to competition from digital disruption and those at the leading edge of digital use are likely to gain significant market advantage as the world becomes increasingly digitally engaged;
- Public services: those that do not become fully engaged face an unaffordable future while bodies at the leading edge of digital use will be best-placed to meet the needs of society;
- People: all of this depends on population-wide digital access and skills.

Digital Sector

A6.93 Scotland has a rapidly growing and diverse digital technologies sector employing over 80,000 people, with more than 1,500 businesses[60], spanning from software development, to games design and production, to data management and analytics, and to telecommunications.

A6.94 There are a host of thriving digital technologies companies originating in Scotland, including for example, Skyscanner, SmarterGridSolutions, LogicNow, FanDuel, and FreeAgent. As well as outstanding Fintech companies such as Nucleus.

A6.95 Digitalisation will continue have an immense impact on the world economy in the coming decades, offering potential in every sector from financial services, to retail, to energy and to marketing. Digital technologies are presenting firms with the opportunity to develop and expand former business models to provide new revenue, markets and value-producing avenues. The digital sector has grown markedly over the past five years and must be identified as a priority growth sector for Scotland, given its potential long-term significance to the wider economy and also to the ability it provides to widen participation and globalisation in an country of Scotland's geographic position and structure.

A6.96 The global drivers, as identified by Scotland-IS include data science, the "internet of things", robotics, automation, virtual and augmented reality, health informatics, digital public services and mobile-first e-commerce. The challenges in this environment are the expected massive discontinuity in employment and that only flexible, fast-moving businesses will survive.

[60] Figures provided to the Commission by Scotland-IS

Digital Skills

A6.97 Scotland's expanding technology sector is increasing the demand for digital skills. A considerably boosted supply of talented and creative individuals is pivotal to the continued growth of the digital technologies sector. Scotland, like much of Europe, already confronts a skills shortage that is limiting the sector's potential for growth. The skills shortage has been aggravated over time by gender imbalance, with women only accounting for approximately 26% of the industry and few holding senior roles or board positions. Digitalisation across the entire economy is further fuelling the demand for digital skills, with many non-technology sectors now requiring digital specialists. All this demand means that over time most jobs will need a deeper understanding of and capability in digital technologies.

Digital Infrastructure

A6.98 Scotland's Economic Strategy recognises that digital technologies are "increasingly critical in the day-to-day operations of businesses and households across Scotland". An important component of the government's economic strategy is the commitment to develop and deliver world class digital infrastructure across Scotland by 2020.

A6.99 Connectivity is the central underpinning of a digital economy, and ultimately also of society as a whole. Substantial headway has been made in delivering broadband across Scotland, but there is yet considerable progress to be made to attain world class digital infrastructure by 2020. The rate of technological innovation continues to raise the benchmarks for acceptable levels of connectivity. The Scottish Council for Development and Industry recommends that after existing programmes are implemented, the minimum target should be to deliver ultrafast broadband at 500Mbps and 5G by 2025, and 1Gbps for key economic locations where there is market demand.

Economic Impacts of Digitalisation

A6.100 Productivity, and its rate of growth, is a key indicator of the strength of an economy, and increasing productivity is considered as being vital to long term economic growth. Technological progress, which leads to increases in productivity in the long run, is one of the principal determinants of economic growth and higher living standards. Over the last several decades, the development and dissemination of new information and communications technology (ICT) has been one of the central drivers of productivity growth, and this trend is likely to continue. Since the global financial crisis in 2007/08, productivity growth in the UK has been particularly weak, and has consistently been underperforming in relation to expectations, and has been called the 'productivity puzzle'. It is probable that a component of this is the weak implementation of innovation in the UK, especially digital technologies.

A6.101 Digitalisation is the strategy and process of adopting recent technologies in IT to develop business models that provide new revenue and value-producing opportunities.

Digitalisation has vast long term economic and social benefits, as well as enhancing public and private sector activity and productivity. A report in 2015 for the Scottish Futures Trust by Deloitte investigated the economic and social impacts of enhanced digitalisation in Scotland[61]. For the report, the Scottish Futures Trust defined three digitalisation outcome scenarios that may evolve in Scotland by 2030, based on analysis undertaken by the Department of Culture, Media and Sport. Scenario 1 was defined as an incremental improvement in digitalisation; scenario 2 was defined as Scotland developing world class digitalisation by 2030; and scenario 3 was defined as Scotland becoming a world leader in digitalisation by 2030. A summary of the results is shown in Table 6-4. Given the remarkable impact on taxation revenues if a longer-term view is taken on the use of public resource for investment the case for this investment to be borne now should be compelling.

Table 6-4: Economic Impact of Enhanced Digitalisation in Scotland by 2030

	Scenario 1	Scenario 2	Scenario 3
GDP	£4 billion	£9.5 billion	£13 billion
GDP per capita	£750	£1,700	£2,500
Business Creation	3,000	4,500	6,000
Job Creation	40,000	120,000	175,000
Exports	£0.8 billion	£2.1 billion	£2.5 billion
Tax Revenues	£1.3 billion	£3.2 billion	£4.5 billion

Source: Deloitte (2015), The economic and social impacts of enhanced digitalisation in Scotland

Science and Innovation

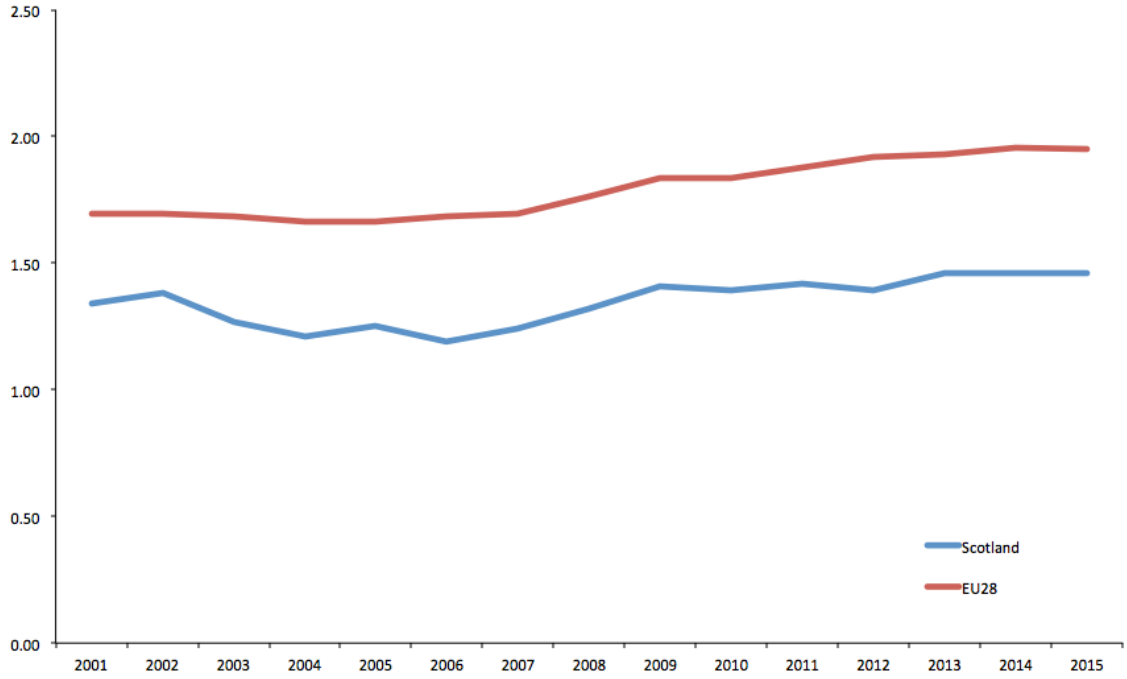
Research and Development Investment

A6.102 Research and development (R&D) is central to the growth of a modern knowledge based economy, as it enables new discoveries to be made that will drive future innovation. Investment in R&D is widely recognized as a key driver of economic growth and has been adopted by the European Commission as one of five interrelated headline targets for the EU to achieve by 2020. The Europe 2020 strategy aims to improve conditions for innovation, research and development, with the objective of increasing combined public and private R&D investment to 3% of GDP.

A6.103 Gross Expenditure on R&D (GERD) encompasses R&D undertaken by Higher Education (HERD), Business Enterprise (BERD), Government (GovERD) and Private Non-Profit (PNP) sectors. In 2015, Scotland's GERD spending (excluding PNP) was 1.46% of GDP; this is lower than for the EU as a whole, which was 1.95% of GDP. It is also significantly lower than for the OECD average, which was 2.4% of GDP (Figure 6-5).

[61] Deloitte (2015), The economic and social impacts of enhanced digitalisation in Scotland

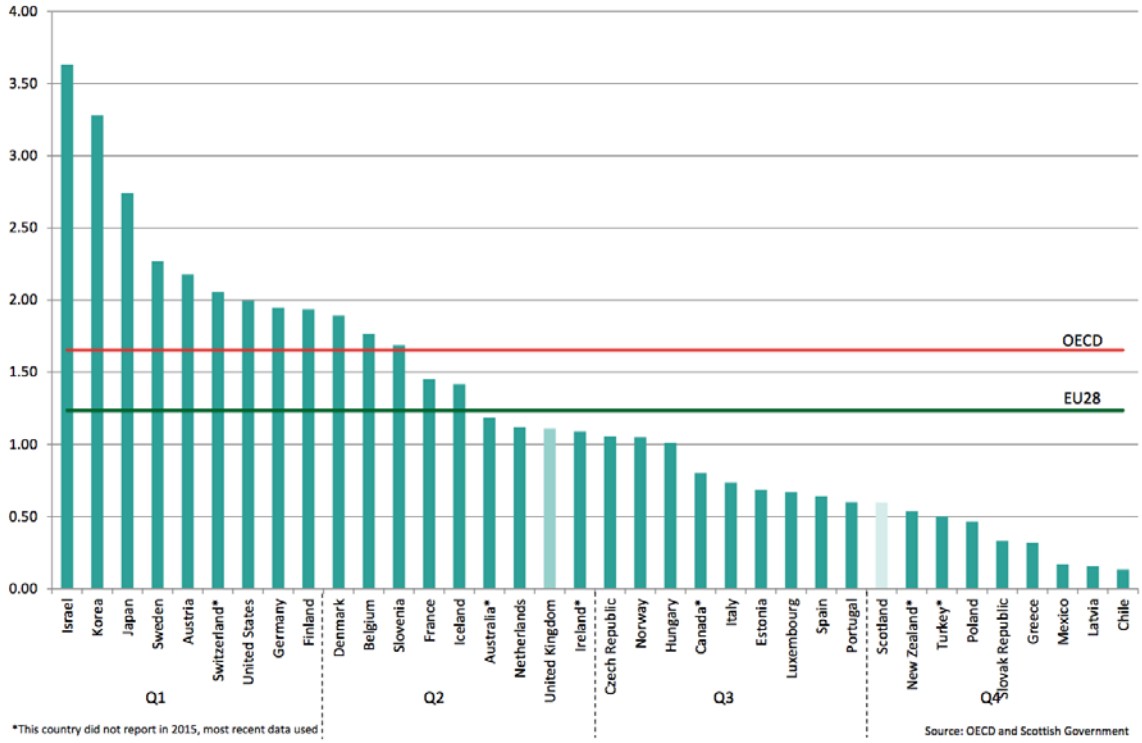
Figure 6-5 – Scotland and EU28 Gross Expenditure R&D as % of GDP (2001 – 2015)



Source: Gross Expenditure on Research and Development Scotland 2015, Scottish Government and Main Science and Technology Indicators 2016/2, OECD

A6.104 Scotland's comparatively low levels of gross R&D expenditure can be attributed to very low levels of Business Enterprise R&D expenditure. In 2015, BERD expenditure in Scotland amounted to 0.6% of GDP, in contrast to 1.23% for the EU28 and 1.65% for the OECD. Figure 6-6 demonstrates the differing levels of BERD expenditure across the OECD, showing that Scotland is in the upper fourth quartile among the OECD nations.

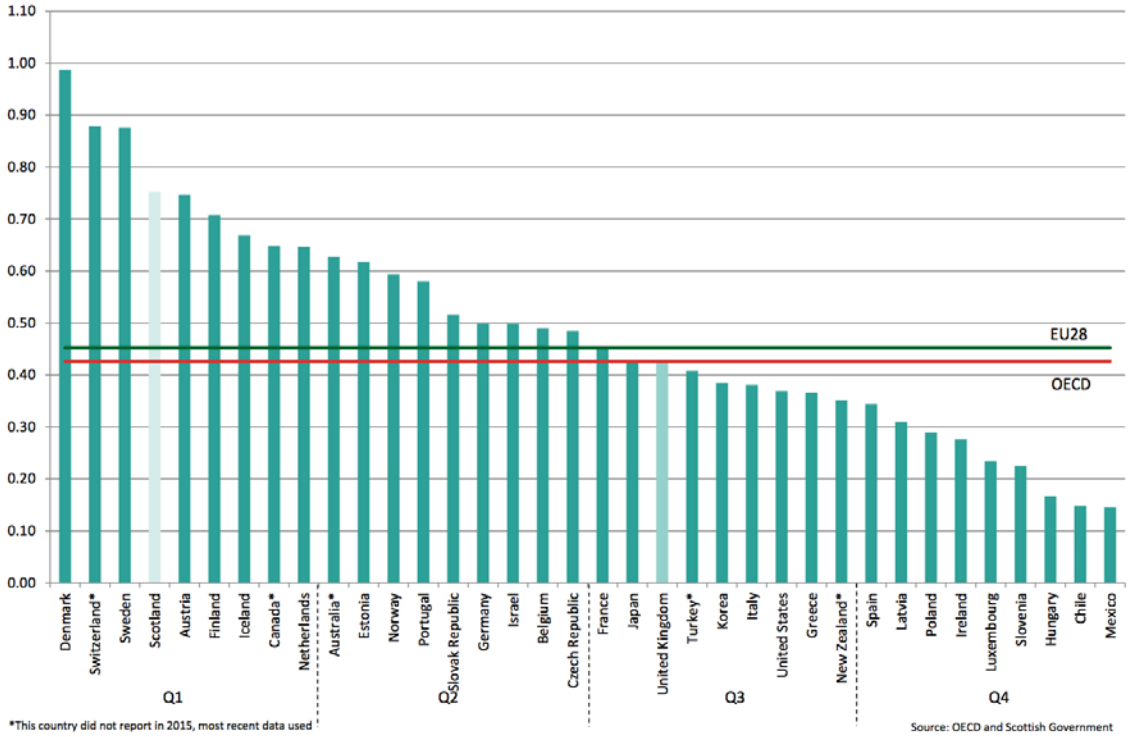
Figure 6-6 – Scotland and OECD Business Enterprise R&D as % of GDP in 2015



Source: Gross Expenditure on Research and Development Scotland 2015, Scottish Government and Main Science and Technology Indicators 2016/2, OECD

A6.105 There is, however, a far greater contribution made towards R&D activity by the higher education sector in Scotland. In 2015, Higher Education R&D in Scotland amassed to 0.75% of GDP, which was 13.6% of the UK total. This far exceeds the EU28 and the OECD, which were 0.45% and 0.43% respectively. Figure 6-7 demonstrates the varying quantities of HERD expenditure across the OECD, showing that Scotland is in the first quartile, behind only Denmark, Switzerland and Sweden.

Figure 6-7 – Scotland and OECD Higher Education R&D as % of GDP in 2015



Source: Gross Expenditure on Research and Development Scotland 2015, Scottish Government and Main Science and Technology Indicators 2016/2, OECD

R&D and Productivity

A6.106 The analysis set out above shows how successful small advanced economies tend to invest heavily in R&D, suggesting that there are potential economic benefits from increasing R&D investment.

A6.107 The positive effects of R&D on productivity has been demonstrated. For example, recent analysis by the IMF[62] shows that, if advanced economies were able to increase private R&D by 40 percent on average, they could increase their GDP by 5 percent in the long term. Given the R&D spending is less than 2 percent of GDP in most advanced economies, this would represent a substantial return on investment. The same IMF analysis also shows positive social returns to public sector investment in R&D.

Universities and Growth

A6.108 There is no doubt that Scotland's university sector is internationally competitive and a source of economic growth.

[62] IMF: April 2016 Fiscal Monitor

A6.109 Five Scottish universities (Edinburgh, Glasgow, St Andrews, Dundee and Aberdeen) are ranked in the top 200 universities in the world[63], which means that only Luxembourg has more leading universities per capita than Scotland.

A6.110 The sector is also highly productive in terms of both the quantity and quality of the science outputs. Analysis undertaken by Elsevier for the Higher Education Funding Council for Wales[64] found that Scotland was top for peer-reviewed scientific publications per year per researcher and was second to the Netherlands for research citations per researcher (a measure of the influence of the findings). In terms of productivity, Scotland was second for both publications and citations per million dollars of government investment in R&D.

A6.111 University impact on the economy is frequently understood either in terms of purchasing power effects of staff and students, or in terms of company formation (spin-outs and start-ups) and other indices of commercialisation of university IP (patents, licences), or both.

A6.112 However, the impacts are wider than that. Some universities are at the leading edge of research that shapes the development and applications of new technologies. Big data technologies, with applications in the life sciences (human, animal and plant), the transition to a low carbon economy, financial services, creative and leisure industries, the internet of things, robotics and artificial intelligence, public services delivery are all examples of strengths in Scottish universities.

A6.113 Additionally, universities at the leading edge of research typically communicate that leading edge in their teaching, producing graduates conversant in the theory, practice and application of new technologies. A number of Scottish universities have a global reach, drawing in and developing outstanding talent from around the world as well as from Scotland and the rest of the UK.

A6.114 The mix of university R&D and the supply of graduate talent has one effect in commercialisation activity. FanDuel is one example – initially a University of Edinburgh student start-up - that has ballooned into unicorn status.

A6.115 But there is a much wider effect. The mix of R&D pipeline and graduate skills can become an attractor for entrepreneurship and inward investment (e.g. the Engage, Invest, Exploit venture funding conference has attracted over £300 million to the Scottish economy in the last few years). The tech sector in Edinburgh is an example which combines a dynamic tech start-up scene (e.g. CodeBase) with established and now high-value companies (FanDuel, Skyscanner, Rockstar North), and local offices of global tech giants (Amazon, Microsoft, IBM, with Intel and Huawei also now developing Edinburgh operations). That tech sector would

[63] Times Higher Education World University Rankings (September 2016)

[64] Elsevier Analytical Services (2016), International Comparative Performance of the Welsh Research Base

not be there without world class university research in computer science and the skilled graduates it produces.

Productivity and Innovation

A6.116 As producers of highly-skilled graduates and postgraduates, generators of world-class research and development and located at the centre of industry clusters, universities contribute to economic growth. In recent years a number of influential economists have published works that set out a theoretical and empirical case for the role that high level skills and innovation play in both boosting economic competitiveness and addressing inequality in society.

A6.117 In the late 1950s Robert Solow published papers that showed that it was not the savings rate or increases in the factors of production (labour and capital) that determined the long-run growth rate, but increases in productivity. In the early 1960s Kenneth Arrow published papers on research and development and on learning by doing, which showed that almost all economic growth could be accounted for by innovation, both new ideas emerging from research and improving productivity through learning by doing during the process of production itself.

A6.118 Building on this, the Nobel prize winning economist Joseph Stiglitz[65] has argued that productivity is the result of learning and consequently, a focal point of policy should be to increase learning within the economy. The observation is made that even within countries and within industries there can be large gaps between the most productive and the others. This means that the diffusion of knowledge is as important as pushing the boundaries of knowledge. Moreover, since productivity growth is what drives growth in the economy, this indicates that there is considerable scope for higher rates of economic growth. As an illustration of this, of the productivity growth that took place in the UK between 2000 and 2008, nearly one third was attributable to changes in technology resulting from science and innovation.[66]

A6.119 The scale of knowledge and innovation that takes place is also important because there are dynamic effects that come into play. New knowledge and innovation (the diffusion of knowledge) are both based on the foundations of prior knowledge and high levels of investment in knowledge and innovation give rise to an accelerating pace of innovation. In contrast, cutting levels of investment in knowledge and innovation, will mean that the pace of innovation slows because underinvestment compounds over time.

[65] Stiglitz and Greenwald (2014), Creating a Learning Society: A New Approach to Growth, Development, and Social Progress.

[66] HM Treasury, Department for Business, Innovation & Skills (2014), *Our Plan for Growth: Science and Innovation*.

A6.120 In summary, knowledge and innovation are fundamental to economic growth, since it is productivity growth that drives economic growth and productivity growth is in turn driven by knowledge and its diffusion (innovation).

Knowledge and Human Capital Creation

A6.121 The two fundamental activities of universities are the creation of intellectual and human capital. Universities contribute to knowledge creation through the basic and applied research that is undertaken. The most influential technologies today and the technologies of the future arise out of this research. Universities also provide high quality graduates for the labour market which in turn increases the innovation potential of the economy, as well as leading to productivity gains for the economy.

Transfer of Existing Knowledge and Technological Innovation

A6.122 Over and above these fundamental activities universities also work to transfer existing knowledge throughout the economy through their interactions with businesses such as through consultancy and workforce training, which increases productivity and business innovation. Universities are also a vital source of technological innovation through the commercialisation activities that they undertake such as spin-out companies and intellectual property licensing.

Knowledge Infrastructure

A6.123 Universities also have a role to play in the production of knowledge infrastructures, which largely arise due to positive agglomeration effects. As an example, many research institutes, and companies choose to locate in close proximity to research intensive universities in order to benefit from informal knowledge sharing as well as frequent face-to face contact with academics involved in research. It is for this reason that cities with universities also have large numbers of associated knowledge infrastructures such as research institutes and science parks, which can ultimately develop into knowledge clusters.

Provision of Leadership

A6.124 Many universities play an important leadership role regionally and nationally, through their involvement in the advisory boards of private, public and non-profit organisations. This ensures a coordinated economic development approach helping to match skills with regional needs and vice versa.

Social Environment – The University Ecosystem

A6.125 Finally universities can have a number of impacts on the local environment. The staff and student base provided by the universities undoubtedly contributes to the overall vibrancy of the cities they are located in.

A6.126 In addition to adding to the quality of the local environment, universities contribute to the attractiveness of a region as a knowledge centre. This wider role of universities in underpinning the economy is something that should not be overlooked. Universities provide a space for discussion and create connections between academia, students and companies that would not otherwise exist and therefore foster an environment for innovation. This creates clusters of people, which lead to the creation of entire university ecosystems, which in turn draw more people.

A6.127 The further impact of the university ecosystem is that it makes these regions the most attractive places to invest and universities are, as a result, vital to drawing inward investment.

A6.128 Universities are major drivers of knowledge and innovation. This is fundamental to economic growth, since it is productivity growth that drives economic growth and productivity growth is in turn driven by knowledge and its diffusion (innovation).

Maximising Economic Contribution of Universities

A6.129 There are opportunities to further leverage the economic contributions of the Scottish universities, by forging closer links between universities and businesses and between universities and the providers of long term 'patient' risk capital, to build the next generation of R&D intensive high growth companies. Opportunities must also exist with the small and medium sized enterprises that dominate the Scottish economy.

A6.130 This is an area where Scotland has already been a pioneer. For example, the Interface programme which matches small businesses that have never worked with universities before with appropriate research teams, has been copied in other countries, most recently in Estonia. However, there is a need and an opportunity to scale up such activity, involving many more businesses. This was the subject of a the Growing Value Scotland Taskforce, set up by the National Council for Universities and Business, which reported last year[67].

A6.131 That work confirmed that there was a strong need for a major uptake of innovation by firms in Scotland and a clear appetite for a step change in the way business-university collaboration is driven.

A6.132 The recommendations included a review of innovation and support for business, a new innovation funding system, addressing the innovation capacity of businesses in Scotland, greater visibility of research undertaken, recognition for the different approaches to innovation taken in different sectors, using fiscal powers to ease business access to risk capital and providing the graduate talent required to realise the opportunities.

A6.133 We recommend a central role for Universities in Scotland's growth strategy and an immediate review of the policies that are required to help them maximise their contribution.

[67] NCUB (2016): Growing Value Scotland Task Force Final Report

Innovation and Role of the State

A6.134 There is a long-running and widely held perception that Scotland is good at the process of discovery and invention but not so good at realising their commercial and economic benefits. In fact the track record of the Scottish universities compared with international benchmarks is good. That said, improving Scotland's track record on commercialising scientific and technological breakthroughs to create companies of scale, based in Scotland, would have significant positive economic impacts.

A6.135 The interaction between government and business in innovation and entrepreneurship has been important in terms of historic economic performance and could be even more important in the future. This is an area that has often been ignored in policy making which focuses on creating conditions for growth that is limited to institutions, macroeconomic management and infrastructure. However, this is also an area where policy makers in several countries are currently examining and considering changes.

A6.136 Professor Mariana Mazzucato[68] (a member of the Scottish Government's Council of Economic Advisors) has reviewed some of the most significant technological breakthroughs, in pharmaceuticals to the internet and some prominent innovative companies, including Apple, and demonstrates how many of the risks taken in the commercialisation of the products, as well as in the research and development, were taken by public sector organisations.

A6.137 The global technology giants of today have developed and commercialised technology that emerged from publicly funded research programmes. However, they also received public investment in commercialisation and in their early growth phases. In the US companies such Apple, Compaq and Intel were supported with funding from the Small Business Innovation Research (SBIR) scheme. Indeed, Silicon Valley has benefitted from the vision of the public sector as well as targeted investment.

A6.138 Mazzucato argues that the role of the state is and should be beyond investing in infrastructure and demand to expand production when the private sector freezes in a downturn and that there is a role in promoting and funding high risk, high reward innovation.

A6.139 She identifies an opportunity for the public sector to invest in innovation in the green economy, as a route to recovery from the current economic crisis. The observation for the global economy is that emerging markets cannot follow the resource and energy intensive path of the past due to limited resources and the brake of global warming. The development of green technologies will therefore find market opportunities and can deliver both economic growth and sustainable development. However, such an approach will

[68] Mariana Mazzucato (2013), The Entrepreneurial State: Debunking Public vs. Private Sector Myths

require both a long-term effort and policy consistency (which she argues has not been the case in the UK).

A6.140 This approach requires the public sector to take a more active role than in correcting market failure; the role includes shaping and creating new markets. Rather than "crowd-out" private investment, the public sector can "dynamise-in" the private sector by creating the vision, mission and plan for innovation.

A6.141 Other areas for action that are worth consideration include:

- supporting private sector R&D; however, if R&D tax credits are used they should be focused on supporting R&D workers, as in the Netherlands, rather than R&D spend (which is more problematic to define);
- setting up an innovation fund, paid for by royalties from successful commercialisation, which can be re-invested in future technologies. This could be achieved by attaching conditions to loans and grants where royalties are paid when profits rise above a threshold (in a similar way as conditions for student loans);
- direct investment in technology companies, by state investment banks (a model that is common in Germany, for example);
- avoiding innovation policies that would not result in profits arising from innovation being re-invested in innovation (such as the UK's preferential tax treatment of profits arising from patents); and
- additional investment in public agencies with a remit for near market research (such as InnovateUK in the case of the UK), investing directly in research through agencies, using the US model of the Defense Advanced Research Projects Agency and, more recently, the Advanced Research Projects Agency – Energy.

A6.142 While some of the policy recommendations represent savings to the taxpayer, rather than costs, in an environment such as Scotland, where the objective would be to make a step change in innovation, it is likely that a net investment will be required. However, there is payback from that investment. For example, the Brazilian State development bank, BNDES, which has been investing in innovation in both cleantech and biotechnology, made a return on equity in excess of 20% in 2010. There are also benefits to the taxpayer from the additional taxes associated with the economic growth stimulated.

A6.143 The focus of the public sector should build on investment in the research base, providing the long-term patient finance required to bring new technologies to market. While it must be accepted that there will be failures as well as successes (since innovation is high risk), the successes can pay for the failures, providing mechanisms are in place for the public sector to share in the proceeds of success.

A6.144 The approach is already being debated by politicians in several European countries (for example, in the Netherlands, Denmark and Norway) and by the European Commission where it is consistent with the Horizon 2020 strategy of delivering smart and inclusive growth. Scotland might be the ideal place to take these policy lessons on board, given the strength of the academic research but the failure to grow and retain companies of scale in Scotland.

A6.145 Twenty years ago, Scottish Enterprise undertook a 'commercialisation inquiry' that considered Scotland's track record in research and development and in commercialisation. That process led to a number of new programmes and investment including the expansion of technology transfer offices, the development of science parks, co-investment schemes (focused mainly on seed and early stage capital), programmes to link businesses with universities, proof of concept funds to assist academics with commercially promising ideas and R&D funding programmes for small companies. Many of these programmes have been replicated in other European countries, where Scotland and the UK are considered to be leaders in innovation and policies to realise economic benefits from the academic research base.

A6.146 The development of a new economic strategy for Scotland presents an opportunity to re-open the commercialisation inquiry to assess the lessons that have been learned over the last 20 years and what action is now required to make the next step in transforming Scotland into an innovation economy. These actions are likely to focus on how to provide long term, patient funding for high growth technology companies. Securing investment may require direct investment by the public sector as well as leveraging in private sector investment. The public sector investment could be from state investment banks, learning from the model that has been successful in Germany.

A6.147 The taxation system can also encourage the provision of long term, patient capital. The returns to the taxpayer from such investment are possible in the form of financial returns from successful companies and economic returns from the growth that is generated.

A6.148 There are other countries that Scotland can learn from in this area, Finland being the most obvious example. During the 2014 referendum campaign, comparisons were made between Scotland and Finland and a commitment was made to establish an Innovation Agency in an independent Scotland, based on the Tekes model in Finland. This is a proposal worthy of being re-examined.

Work Based Skills and Innovation

A6.149 The focus of innovation policies should not be entirely on science and technology. As Professor Ewart Keep has previously identified[69], innovation and inclusion is more likely to be realised when people have more discretion and control at work and learning is built into

[69] Working Together Review (2014), Progressive Workplace Policies in Scotland

what people do, not as a one off. Keep's analysis shows that in the UK only around one third of people work in Discretionary Learning jobs.

A6.150 The characteristic of a discretionary learning environment include:

- confidence and trust in managers and colleagues;
- learning from experience, positive or negative;
- discussing and reviewing learning opportunities; and
- giving and receiving feedback without blame.

A6.151 Discretionary learning is prevalent when businesses don't simply embrace a competitive strategy based on the delivery of standardised, low specification goods or services, but rather believe that workers at all levels in the organisation can contribute to innovation. As a result leaders organise work and management systems in ways that facilitate this objective.

A6.152 The challenge for Scotland is how to enable more organisations to develop and embed business strategies and leadership and management skills which drive innovation by creating an inclusive, development working environment in which people are given the full opportunity to contribute and participate. This requires a different approach to leadership and management than that which has served a top down, shareholder led model over recent decades, as set out in the 2014 Working Together Review.

A6.153 The Fair Work Convention has highlighted the benefits of the partnership approach in which employers and employees work together with shared interests. Scottish Enterprise, Highlands and Islands Enterprise and Skills Development Scotland, along with the recently rebranded Remarkable (formerly Investors in People Scotland) are already developing and implementing approaches drawing on international models of good practice. This should not compete with the range of private sector provision which is available for employers, but should lead the way in challenging some of the existing orthodoxies and perceptions about what "good leadership" means in a 21st century knowledge based economy.

A6.154 Everyone, in every job in Scotland has a contribution to make to our future prosperity. An economy in which people are developed to their full potential in meaningful jobs will be more successful than one in which significant numbers of people feel under-valued, or where their skills aren't used to best effect, and where they feel disengaged from the purpose of their employer.

A6.155 This goes way beyond the mantra that "our people are our greatest asset". We need to move on from thinking of employees as "assets" or "human resources" and more of being real people and individuals, with each person capable of being developed to their full potential, and whose well being is directly impacted by the way work is organised and the quality of interactions with colleagues and leaders.

A6.156 That can be a cornerstone of a progressive strategy which not only supports economic growth, but enables outstanding public service.

Infrastructure

A6.157 While economic growth in an advanced economy depends on productivity growth, driven in turn by human capital and innovation, the foundations required for growth include infrastructure that meets the needs of a changing economy. The Economist newspaper has described infrastructure as: "*The economic arteries and veins; roads, ports, railways, airports, power lines, pipes and wires that enable people, goods, commodities, water, energy and information to move about efficiently.*"

A6.158 Empirical evidence from the OECD[70] has concluded that investment in network infrastructure can boost long-term economic growth in advanced economies as a result of the effect of the capital investment and because of its impact on economies of scale, network externalities and competition enhancing effects. The UK Government's National Infrastructure Plan[71] identifies a number of specific ways that investment in infrastructure can increase productivity, by enabling businesses to:

- sell products to customers more efficiently (e.g. through quicker and cheaper transport of goods, services or data, or lower costs of production);
- produce higher value products, including new intellectual capital (e.g. through improved facilities for research and innovation); and
- access larger markets (e.g. through improved links between production centres and ports/airports or through internet sales).

Benefits of Infrastructure Investment

A6.159 The Civil Engineering Contractors Association (CECA) recommends that investment in infrastructure should be maintained at least at 0.8% of GDP. For Scotland that would be £1.2 billion per annum and given the historic under-investment in infrastructure, there may be a case for substantially higher levels of investment over 5-10 years.

A6.160 To put this in some context, the new Queensferry Crossing, the biggest ever infrastructure project in Scotland is budgeted at around £1.4 billion, with construction taking place over a five-year period. The M74 extension in Glasgow cost almost £700 million.

A6.161 CECA estimates that the cost to the UK economy of failing to increase infrastructure investment back to the levels more typical for advanced economies (0.8% of GDP) could

[70] Balazs Egert, Tomasz Kozluk & Douglas Sutherland (March 2009), Infrastructure and Growth: Empirical Evidence, OECD Economics Department Working Paper 685

[71] HM Treasury (2011), National Infrastructure Plan

be an annual loss to the economy of some £90 billion by 2026. Scotland's share of that loss could be at least £7.5 billion per annum.

A6.162 However, investment in infrastructure generates both immediate economic impacts and a sustained contribution to economic growth. CECA estimates that each £1 billion in infrastructure investment:

- increases GDP by £1.3 billion as a result of economic multiplier effects (e.g. associated supplies for the construction and the knock-on benefits from construction employment); and
- increases overall economic activity by £2.8 billion, by creating a competitive environment for business.

A6.163 An increase in economic activity of this scale would be expected to generate tax revenues by £1 billion.

A6.164 The role of infrastructure could be even more important to the future of the Scottish economy than in the past. The growth and economic dominance of London is not an isolated phenomenon; other large global cities have grown, taking advantage of agglomeration effects, where businesses and people clustering together deliver economies of scale from network effects to drive economic growth. If Scotland is to compete in such a global environment, the role of infrastructure in connecting the main cities and towns, physically and virtually, becomes more important.

Approach to Infrastructure Investment

A6.165 Decisions on infrastructure investment in the UK and in Scotland tend to be made on a case-by-case basis. There are well-developed processes in place to prepare and assess cases for investment. These include, for example, the Scottish Transport Appraisal Guidance (STAG) system of appraising transport projects.

A6.166 A STAG appraisal is prepared when Government funding, support or approval is required for transport projects. The STAG appraisal system is comprehensive and claims to be objective-led rather than solution-led, that is, designed to start with a definition of the transport problem rather than a pre-conceived solution.

A6.167 However, the starting point for such analysis is the current transport system and a set of objectives for changing it. Moreover, in most cases the STAG is undertaken by or commissioned by the local authority or transport authority promoting a project and so a STAG appraisal that identifies an alternative solution to the proposed project would be rare.

A6.168 An alternative approach would be more strategic, taking the national economic strategy as the starting point and identifying the investments required in pursuit of the objectives set out. It seems likely that such an approach would generate a long list of projects, far in excess of the capital funding likely to be available. However, the advantage of an approach which

takes the national economic strategy as a starting point is that projects are not accepted or rejected for funding; rather they are prioritised in a long-term programme, with projects that will do most to facilitate economic growth given the highest priority.

A6.169 The example of the process used in Ireland shows how such a strategic approach to infrastructure investment can work.

Ireland's National Development Plan

A6.170 While Ireland's infrastructure challenges were far greater than those of Scotland, the approach that was taken is a useful case study for the delivery of significant improvements within one generation. Anyone who lived, worked or visited Ireland in the 1980s or even in the 1990s as "Celtic Tiger" economic growth rates were being delivered, will remember long and frustrating journeys between the major cities and towns. Ireland now has a motorway network and has invested in rail and other public transport capital, such as the bus fleet.

A6.171 In most countries, infrastructure projects are assessed on a project-by-project basis, sometimes based on cost benefit analysis cases and sometimes on political priorities. Infrastructure plans are often published, but these are often summaries of previously announced spending priorities.

A6.172 A more strategic approach has been taken in Ireland with the first National Development Plan (NDP), published in 1999, covering the seven-year period 2000-06. The NDP also served as the Operational Programme document for prioritising European funding with €1.42 billion of the €26 billion of investment from the EU regional development and cohesion funds. The plan set out a range of proposed spending priorities covering national roads and public transport, environmental infrastructure, sustainable energy, housing and health facilities, in order to meet a number of objectives:

- maintaining sustainable national economic and employment growth;
- the consolidation and improvement of Ireland's international competitiveness;
- fostering balanced regional development; and
- promoting social inclusion.

A6.173 A second NDP covered the period 2007 to 2013, was bigger in scale (setting out €187 million of infrastructure investment) and wider in scope, covering economic infrastructure (transport, energy, environment and ICT), enterprise, science and innovation (investment in the R&D base, foreign direct investment, indigenous business development, tourism and rural development), human capital (skills development, modernising schools and higher education), social infrastructure (housing, health, justice, culture and sport) and social inclusion (pre-school education, social and economic participation, older people, people with disabilities and local and community development).

A6.174 The advantage of the approach taken by Ireland is that infrastructure investment can be prioritised based on economic and social policy priorities. The NPD also provided a mechanism for achieving a broad consensus across the political spectrum and in wider society, including businesses and trade unions.

A6.175 The development of the NDP involved extensive consultation, in particular with the social partners (the Government, representatives of industry such as the Irish Business and Employers Confederation and the Construction Industry Federation, trade union representatives the Irish Congress of Trades Unions, the voluntary and community sector) as well as research into Ireland's economic and social needs and opportunities and evaluations of the previous NDP.

A6.176 Another feature of the NDP was the integration of different measures. So, for example, a regional dimension focused more per capita resources in the Border, Midland and Western (BMW) region and ensured that the transport and other infrastructure was in place to service greenfield industrial sites which were the focus of inward investment promotional activities.

Scotland's Infrastructure Needs

A6.177 While the Irish approach to infrastructure planning has been highlighted as an example, the position of Scotland's infrastructure is not comparable with the situation faced by Ireland in the late 1990s, which, for example, still had a road network that predated the acceleration of Irish economic growth and was constraining further growth.

A6.178 However, the business leaders who have contributed their views to N-56 believe that Scotland has less well developed infrastructure than many of its competitors and the analysis presented earlier shows how UK investment in infrastructure has been in long term decline.

A6.179 In the context of the Scottish economy, there are two types of infrastructure investment that could drive economic growth.

A6.180 The first applies to any advanced economy and consists of infrastructure investment that facilitates productivity growth. This would include:

- physical infrastructure such as transport and information and communications technologies (including net generation access broadband) which can deliver better market access and efficiency gains; and
- investments that might be expected to deliver innovation and technological advance (such as investment in the R&D base).

A6.181 Such priorities would need to be well integrated with Scotland's economic strategy. So, for example, if renewable energy continued to be a priority, then infrastructure priorities should include electricity grid development (including investment in grid technologies, the domestic grid and international grid connections).

A6.182 The second would be based on an assessment of any particular opportunities that might exist given Scotland's particular circumstances.

Infrastructure Needs and Business Opportunities

A6.183 Airport and port services are two areas where Scotland's geographical location presents opportunities that are worthy of further examination.

A6.184 One potential project could be the development of hub airport services, in the same way that other small advanced economies including Denmark, Finland and, Iceland have done. Scotland is particularly well placed geographically to be a European hub for links to North America.

A6.185 An increase in international air connections with Scotland would also have the advantage of addressing the concerns of business leaders and the tourism industry about air links to London and other global business and population hubs.

A6.186 Scotland is well placed for air transport links between North America and Europe. However, Edinburgh airport, with 9.8 million passengers in 2013 was Europe's 42nd busiest airport and Glasgow, with 7.4 million passengers in 2013 was the 59th busiest. To put this in context, the four busiest air hubs in Europe in 2013 were London Heathrow (72.4 million passengers), Paris Charles de Gaulle (62.3 million), Frankfort (57.5 million) and Amsterdam (52.6 million).

A6.187 While it might not be realistic for Scottish hub airports to compete with the busiest hubs in Europe, the development of Copenhagen airport demonstrates what might be possible. With 24.1 million passengers in 2013, it was Europe's 16th busiest airport. It is the hub for Scandinavian Airlines (SAS) and for Norwegian and has flights operated by most European airlines and other international carriers. Passenger numbers have increased from 17 million in 1998 and there are plans to increase to 40 million. The airport is well connected by road and rail to Copenhagen and the rest of Denmark and, via the Oresund Bridge, to Sweden.

A6.188 Another example of an airport development that has taken advantage of its geographic position, despite a limited domestic market, is Iceland's Keflavik International Airport. While it only has 2.8 million passengers a year, the population of Iceland is only 300,000 and the development of hub services has allowed regular flights to both North American and European cities, reducing Iceland's peripheral disadvantages.

A6.189 There may also be an opportunity for Scotland associated the increasing use of the Northern Sea Route linking the Pacific and Atlantic, north of Norway and Russia (as an alternative to the Suez Canal).

A6.190 While hub airport services and an international freight port would provide services to Scottish businesses and residents, their feasibility will depend on securing a share of European and global markets.

A6.191 The development of hub services at Scottish airports and of improved sea freight services would lower the barriers to exporting for Scottish companies and could also help to ease the congestion at the London airports, particularly Heathrow.

Transport Links within the UK

A6.192 Transport links between Scotland and the rest of the UK will continue to be important since the rest of the UK is an important market for Scottish firms (and Scotland is the second largest 'export' market for rest of UK firms, after the United States).

A6.193 The development of High Speed Two (HS2) rail links could improve these links, and deliver significant economic benefits for Great Britain (the business case[72] puts the net benefits of phase one and phase two at £70 billion, and possibly as high as £99 billion). However, the majority of the wider economic impacts will be delivered when HS2 moves into phase two, north of Birmingham.

A6.194 However, the planning of the project has assumed that the construction will start in London; consideration should be given to also constructing connecting high speed services from Scotland. This would improve transport connections between Scotland and Northern English cities as well as with London. There would also be environmental benefits associated with reduced demand for short haul air services.

Internal Infrastructure Priorities

A6.195 Global trends such as the growth of global cities, taking advantage of agglomeration effects, also means that road and rail infrastructure that improves access between Scotland's centres of population will become increasingly important to competitiveness, to facilitate the development of critical mass in key economic clusters.

A6.196 However, planning should avoid focusing on connecting the rest of Scotland with the capital since that could lead to the economic dominance of the economy by one city, in the same way as has happened in the UK as a whole. Given the distribution of the Scottish economy a networked approach is more appropriate than a 'hub and spokes' centralisation of activity.

A6.197 It is not the role of this report to identify individual projects. Indeed, the recommended approach to infrastructure planning is that it should be driven by the priorities set out in the economic strategy. This has not always been the case for transport planning in Scotland. For example, the Scottish railway franchise has only recently had tourism issues added as one of the requirements of the bidding process.

[72] Department of Transport (October 2013), The Economic Case for HS2

Funding Model for Infrastructure

A6.198 The Scottish Government's Infrastructure Investment Plan shows capital investment of between £2.1 billion and £2.7 billion per year over the period to 2029-30. This includes social infrastructure (health, schools, further and higher education, culture, housing, regeneration, justice and sport) as well as economic infrastructure (transport, digital, energy, water and environment).

A6.199 As discussed earlier, CECA recommends that investment in (economic) infrastructure should be maintained at least at 0.8% of GDP and there may be a case for substantially higher levels of investment over the next 5-10 years to address historic under-investment in infrastructure. It seems unlikely that this will be possible under current capital budgets.

A6.200 However, investment in infrastructure need not be entirely funded from public sector sources. By definition, the benefits of infrastructure are long term and so there is merit in also spreading costs out over time.

A6.201 One potential model would be Scottish Infrastructure Bonds, which could be offered to international bond markets and as domestic savings products. The long-term nature of infrastructure projects is a good fit with the increasing need for long term savings products that will increasingly be required as the ageing population structure increases the need to save to fund pensions.

A6.202 The feasibility of such a model for Scotland should be examined, since it has the potential to both address the need for pension and saving reforms and expansion and the need to invest in infrastructure to facilitate acceleration of economic growth. The model may require taxation treatment that promotes the long-term savings that would be required to encourage take-up.

Infrastructure Commission

A6.203 The case for greater investment in infrastructure is a powerful one. However, the returns on such investment could vary greatly depending on the decisions that are made on the priorities for investment. These can be difficult decisions, since they require view to be taken on technological change as well as future demand (for example, will cable based broadband or next generation mobile be the dominant internet infrastructure of the future and should planning trunk road investment take account of the potential for autonomous vehicles in the future).

A6.204 While certainty is never possible, the likelihood of making the right judgments on infrastructure priorities can be increased by putting in place the institutions to undertake the horizon scanning and research to inform such judgements.

A6.205 There is also merit in recognising that these are long term decisions and so there is a need for advice that looks beyond the current infrastructure constraints and short term opportunities, and beyond the political cycle.

A6.206 An Infrastructure Commission should be established to provide this strategic advice, based on a research programme, to align investment with long term economic development aspirations.

National Investment Bank

A6.207 We very much welcome that the latest Programme for Government included a commitment to the creation of a National Investment Bank. We suggest that it is critical that in creating this the model should accommodate longer term risk bearing investments. The participation of the bank with other investors on projects such as life sciences, technology, science innovation, energy innovation where the public sector can play an important role. Similarly, the bank can help leverage investment into housing and other infrastructure and participate alongside other long-term investors to the benefit of the broader economy. We also encourage that this policy move is considered alongside a more comprehensive review of policy in this area and the organisations and structures that deliver it from local government to national agencies. The Scottish Futures Trust is well established and well placed to lead this work.

Conclusion

A6.208 This chapter has considered the key areas of focus we judge to be important for boosting Scotland's productivity and competitiveness. We have avoided a specific sectors strategy and as a result, there are, of course, many specific industrial policy actions that could be further considered. We have therefore identified the 6 specific areas of focus: global competitiveness standards; trade and market access; digital infrastructure and skills; science and innovation; workplace skills and learning and infrastructure. This is not the last word, but we hope it provides priorities for focus and action that can deliver the most substantial and tangible benefits from policy.

A6.209 Every bit as important as these initiatives is choosing what government can cease to do, resource and prioritise and our final recommendation in this section is for the economic strategy to contain a 'Stop' programme to ensure focus and efficient use of resource.

Key Recommendations

A6.210 **Frictionless borders and market access:** Securing frictionless borders with the rUK and EU should be a top strategic priority of the Scottish Government. Brexit places a material risk on Scotland's access to export and import markets and the free movement of people, capital, goods and services and must therefore be resisted vigorously. The alternative will be a severe reduction in living standards, growth and employment levels. Scotland has more at stake than most small nations in the coherence of the process of fair global

integration. The lessons of the Scottish enlightenment and history since must be kept front of mind by all.

A6.211 **Competitiveness rankings:** Improving the rankings of Scotland in the main competitiveness rankings should be a core long-term aim of economic policy and the trade-offs involved considered and solutions agreed for the long term.

A6.212 **Competitive Business Taxation:** As part of the review of taxation recommended in Part B we recommend that the impact of business taxation on growth performance is carefully assessed. We are interested in the potential to tailor the Dutch R&D tax credit scheme, enhance incentives for longer term equity investment and improve capital allowances. While we do not consider that competitive use of profit taxation (corporation tax) is an optimal strategic tool, we do recommend that the headline rate of corporation tax should not rise above the level prevailing in the rest of the UK. As with all taxation the impact of the overall structure on both the tax base and revenue generation should be carefully assessed to ensure the more effective system is deployed.

A6.213 **Engagement of International Companies and Sectors**: organisational capacity should urgently be designed and recruited to create and support sector facing business Ambassadors, building on and increasing the prominence of the Global Scots network. This is intended to create a world class dialogue and engagement with those major companies located in Scotland or considering investing in a presence in Scotland to ensure opportunities are maximized and risks mitigated.

A6.214 **Improved data and analysis**: There are gaps in the data that are available on Scotland's trade balance, and on the wider balance of payments position which should be addressed in the short so that the evidence is available on which decisions on policy and assessments of its success can be based. This is an immediate priority.

A6.215 **Infrastructure Commission**: An Infrastructure Commission should be established to provide strategic advice, based on a research programme, to align investment with long term economic development aspirations. This should engage across sectors to seek a national agreement on the long-term priorities and plan. A significant increase in annual investment should be costed and the best means of delivering it identified. If 0.8% of GDP is identified as a go-ahead optimal steady state by some, there is a strong case for a significant increase in this in the short to medium term to ensure catch up in digital and physical infrastructure which will further carry economic benefits that could secure the 'pay-back' to investment in due course.

A6.216 **An Export Growth Strategy** should be created urgently in consultation with the main exporting sectors, companies and potential exporters especially in smaller companies. The aim of this strategy must be to dramatically increase the value of exports overall and to diversify the source of export income very considerably as countries such as Ireland have achieved in recent decades. The promotion of Scotland's exports should be a central part

of the marketing effort of the country alongside migration encouragement. Measures could include the following elements:

- establish a Ministry for Trade and Foreign Affairs to oversee a new and heavily integrated approach to trade, investment and economic diplomacy;
- build a new embassy and consular network with economic diplomacy as its core purpose and with the ability to help harness and direct all of Scotland's international activity;
- retain the link between internationalisation and wider business support through the enterprise networks but with increasing emphasis on, and incentivisation of, growing the number of domestic firms engaged in exporting activity;
- establish a stronger, better funded inward investment agency with an independent and high level Board including representatives of indigenous and investor business communities;
- direct more resources to trade and internationalisation activities recognising that comparator countries spend more on supporting exports, attracting inward investment and promoting tourism than Scotland currently does; and
- provide financial support mechanisms for exporting businesses e.g. export credit guarantees that are at least as generous as those provided in comparator nations.

A6.217 **National brand strategy**: The development of a national brand and campaign is critical to support broader export. Increasing Scotland's position in the Anholt-GfK Roper Nation Brands Index is a useful benchmark. Resourcing of national brand strategy: The investment in marketing and communications behind Scotland's reputation internationally must be review urgently and benchmarked against the scale and effectiveness of Ireland, New Zealand and Norway, which would imply a ten-fold increase in resourcing. A longer-term view of risk and reward should be central to the judgement on the investment level and major exporters engaged to enhance the overall offer.

A6.218 **National Digitalisation 2030 Strategy**: a core focus on growth strategy must be the adoption of the target to become a world leader in digitalisation by 2030, building on the Scottish Government's Digital Strategy. A report by Deloitte for the Scottish Futures Trust suggests this could deliver £13 billion to GDP, 175,000 jobs, £2.5 billion in exports and £4.5 billion in tax revenues. The Scottish Futures Trust should be asked to create this strategy immediately identifying the measures required, the role of government and the collaboration needed by the private and other sectors.

A6.219 **Universities Growth Strategy Review**: We recommend a central role for Universities in Scotland's growth strategy and an immediate review of the policies that are required to help them maximise their contribution. This should be led by a combination of academic, investment, business and policymakers.

A6.220 **Government Led Innovation Review**: There should be a policy review to assess the impact of previous interventions and to identify the policy requirements to close the R&D gap, improve the commercialisation performance and identify the role of workplace skills in innovation and the creation of a learning economy. Tax measures such as a Dutch-style R&D tax credit scheme and need for a innovation agency such as Finland's Tekes should both be subject of feasibility studies.

A6.221 **Top 5 Strategic Development Projects**: at any one point in time we recommend that the Scottish Government, Local Authorities and Economic Development agencies should combine to select the top 5 strategic sites for urgent economic development and devote leadership effort and resource to fast-track them. These are likely to be in or around the main cities where the anticipated return on investment is greatest and likely to unlock greater economic activity. The focus of these projects is likely to combine infrastructure, transport and commercial property and residential development in some combination. The Infrastructure Commission could lead the process of selection and oversee delivery. Hub airport development and the opportunity for a freight hub could be specific opportunities to investigate further.

A6.222 **Scottish National Investment Bank**: We support the creation of the SNIB and recommend that the bank participates with other investors on long-term risk bearing projects requiring equity investment and return. We further recommend that this policy move is considered alongside a more comprehensive review of policy in this area and the organisations and structures that deliver it from local government to national agencies. Close co-ordination with the British Business Bank and its investment priorities would make sense short, medium and long term as would an equivalent dialogue with the Irish Government.

A6.223 **Housing and Growth**: A target should be set for all tenures of housing construction to align to broader migration and population strategy and the development of the planning process. In particular all options should be considered to ensure the investment is made in high quality housing that is far more affordable at all levels than at present. Housing should be seen as an integral part of economic and competitiveness strategy.

A6.224 **Stop Strategy**: It is a relatively simple task to identify more tasks, resources and initiatives that any organisation must engage to improve its performance. It is far more difficult to ensure it stops doing peripheral activity or less impactful work. As part of the economic strategy it is critical that this is a work stream that is prioritised and resourced under senior leadership and governance.

A7 PART A: SUMMARY OF MAIN RECOMMENDATIONS

A7.1 Throughout the report a number of recommendations are made. We encourage all of these to be considered immediately in terms both of what can be achieved now. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached and co-operation sought for policies that would benefit Scotland's performance long-term.

1. **National Economic Strategy:** The creation of an overarching national economic strategy that (as far as is possible) focuses on long term goals and secures broad cross partisan and sectoral support should be the central goal of growth policy. This is and of itself a necessary but not sufficient factor for success. **Growth goals:** The Strategy should include globally ambitious growth goals, to i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.

2. **Next Generation Economic Model**: A national debate should be commenced on the model we seek for the long-term. Choosing matters and the manner of choosing helps determine the sustainability of the choice, since the central lesson from the success of small advanced economies is that they have achieved consensus about long-term priorities and have a collaborative approach to pursuing those priorities. Our recommended starting point for that national debate, is based on learning the lessons from benchmark small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. The features of that model (leaning especially on the lessons of Denmark, Finland and New Zealand) include: quality of governance, long-term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location, placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective.

3. **Delivering Cross-Partisanship and Collaboration:** A cross-partisan collaborative approach to policymaking against the long-term national strategic framework should be institutionalised. Direct engagement across sectors, business representative, employee representative and other policy groups should be institutionalised to ensure that the national economic strategy remains a vital and dynamic part of policymaking.

4. **Identifying comparative advantage and strategic priority sectors**: while we are leery of the idea of 'picking winners' a clear choice should be considered in identifying and promoting those areas (rather than particular firms) in which we judge the Scottish economy to have sustainable comparative advantage. The process of selecting strategic priorities should be a key output of the process identified in (2) and (3).

5. **Productivity Commission**. We recommend the establishing of a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model if appropriate.

6. **Frictionless borders and market access:** Securing frictionless borders with the rUK and EU should be a top strategic priority of the Scottish Government. Brexit places a material risk on Scotland's access to export and import markets and the free movement of people, capital, goods and services and must therefore be resisted vigorously. The alternative will be a severe reduction in living standards, growth and employment levels. Scotland has more at stake than most small nations in the coherence of the process of fair global integration. The lessons of the Scottish enlightenment and history since must be kept front of mind by all.

7. **Population growth**: Targeting a growing population of working age and the attraction of talented migrants should be a top priority of Scottish Government economic policy and marketed vigorously to the rest of the UK and the world. Scotland should seek to be regarded as the most talent friendly country in the world.

8. **A new 'Come to Scotland' package** should be created with a package of incentives including:

   - A 'transition relief' package of tax incentives to reduce the cost of moving to Scotland, and for graduates of Scottish Universities to stay on should be the headline instrument.
   - A reduced capital threshold for investors who are required to provide this
   - A reduced investment threshold for business start-ups
   - A new visa system benchmarked on the most efficient and easy to use in the world

9. **Marketing of 'Come to Scotland':** The marketing of this package and the overall approach should be a major part of the country's international and UK marketing investment and the communications strategy for the internationally facing Scottish

agencies. As far as possible the intention will be to secure cross partisan support for the whole approach which also attracts engagement from our major employers, exporters and universities. The budget should reflect the priority as should the engagement of senior Ministers and officials.

10. **Celebration of the contribution of migrants**: A complimentary programme of internally focused public engagement on the contribution of our migrant and 'new Scots' communities should be embedded in the work of the Government, Local Authorities and across Parliament.

11. **International Students and Graduates**: The attraction and retention of international students should be a priority of policy and changes made immediately to alleviate the constraints caused by UK policy. These changes should include both visa changes to allow more students to stay in Scotland long enough to secure employment appropriate to their qualifications and tax incentives for the first three years of employment (in recognition of the social, economic and exchequer contributions already made).

12. **International Government and Multi-national Organisation Strategy**: One of the existing internationally facing elements of the Government or indeed a combined international department or agency should be tasked with creating a strategy for engagement and transitioning of the staff of international governments and multi-national organisations to Scotland. As well as providing a great home for countries and organisations that wish to engage with Scotland the strategy should aim to provide a home for as many international facing organisations in function or headquarter as is possible. A warm welcome should be matched with a professional service to ease transition cost-effectively.

13. **A Commission on Gender Pay Equality** should be created with a remit to consult and engage across the economy and consider the best policies and incentives to produce a purposeful reduction in the gap with the performance of the best performing small advanced economies, especially New Zealand.

14. **The JRF target of a 50% reduction of poverty to 10%** of the population should be agreed within a stretching but achievable time frame. This policy should be elevated to central strategic importance in the overall strategy and prioritised accordingly in resource allocation.

15. **Long term strategy on participation and inclusion**: agreement should be sought on the central importance of participation and inclusion to sustainable economic growth and a

framework set up to oversee long term policy intervention and resource allocation from e.g. The Fund for Future Generations. Whilst inclusive growth is already a policy priority of the Scottish Government, the full powers of independence will provide an opportunity to expand the priority across all policy areas that can contribute, including fiscal policy, industrial strategy, social security, economic participation and fair work, education and skills and community engagement. **Strategic communication on the costs of inequality** should be a priority of government and political strategies. It is important to build a wider public understanding of the realities of the short and long-term costs so that agreement and support can be obtained for longer term interventions.

16. **Labour markets and flexicurity**: Scotland can learn from Denmark and move to a flexicurity model, with flexible labour markets but without the insecurity the UK benefits system promotes. This would be expected to deliver lower unemployment, particularly lower youth unemployment and enhance productivity by stabilising investment incentives. We recommend a consultation of how a move can be made to establish a Scottish flexicurity model.

17. **Competitiveness rankings:** Improving the rankings of Scotland in the main competitiveness rankings should be a core long-term aim of economic policy and the trade-offs involved considered and solutions agreed for the long term.

18. **Competitive Business Taxation:** As part of the review of taxation recommended in Part B we recommend that the impact of business taxation on growth performance is carefully assessed. We are interested in the potential to tailor the Dutch R&D tax credit scheme, enhance incentives for longer term equity investment and improve capital allowances. While we do not consider that competitive use of profit taxation (corporation tax) is an optimal strategic tool, we do recommend that the headline rate of corporation tax should not rise above the level prevailing in the rest of the UK. As with all taxation the impact of the overall structure on both the tax base and revenue generation should be carefully assessed to ensure the more effective system is deployed.

19. **Engagement of International Companies and Sectors**: organisational capacity should urgently be designed and recruited to create and support sector facing business Ambassadors, building on and increasing the prominence of the Global Scots network. This is intended to create a world class dialogue and engagement with those major companies located in Scotland or considering investing in a presence in Scotland to ensure opportunities are maximized and risks mitigated.

20. **Improved data and analysis**: There are gaps in the data that are available on Scotland's trade balance, and on the wider balance of payments position which should be addressed in the short so that the evidence is available on which decisions on policy and assessments of its success can be based. This is an immediate priority.

21. **Infrastructure Commission**: An Infrastructure Commission should be established to provide strategic advice, based on a research programme, to align investment with long term economic development aspirations. This should engage across sectors to seek a national agreement on the long-term priorities and plan. A significant increase in annual investment should be costed and the best means of delivering it identified. If 0.8% of GDP is identified as a go-ahead optimal steady state by some, there is a strong case for a significant increase in this in the short to medium term to ensure catch up in digital and physical infrastructure which will further carry economic benefits that could secure the 'pay-back' to investment in due course.

22. An **Export Growth Strategy** should be created urgently in consultation with the main exporting sectors, companies and potential exporters especially in smaller companies. The aim of this strategy must be to dramatically increase the value of exports overall and to diversify the source of export income very considerably as countries such as Ireland have achieved in recent decades. The promotion of Scotland's exports should be a central part of the marketing effort of the country alongside migration encouragement. Measures could include the following elements:

    - establish a Ministry for Trade and Foreign Affairs to oversee a new and heavily integrated approach to trade, investment and economic diplomacy;
    - build a new embassy and consular network with economic diplomacy as its core purpose and with the ability to help harness and direct all of Scotland's international activity;
    - retain the link between internationalisation and wider business support through the enterprise networks but with increasing emphasis on, and incentivisation of, growing the number of domestic firms engaged in exporting activity;
    - establish a stronger, better funded inward investment agency with an independent and high level Board including representatives of indigenous and investor business communities;
    - direct more resources to trade and internationalisation activities recognising that comparator countries spend more on supporting exports, attracting inward investment and promoting tourism than Scotland currently does; and

- provide financial support mechanisms for exporting businesses e.g. export credit guarantees that are at least as generous as those provided in comparator nations.

23. National brand strategy: The development of a national brand and campaign is critical to support broader export. Increasing Scotland's position in the Anholt-GfK Roper Nation Brands Index is a useful benchmark. Resourcing of national brand strategy: The investment in marketing and communications behind Scotland's reputation internationally must be review urgently and benchmarked against the scale and effectiveness of Ireland, New Zealand and Norway, which would imply a ten-fold increase in resourcing. A longer-term view of risk and reward should be central to the judgement on the investment level and major exporters engaged to enhance the overall offer.

24. National Digitalisation 2030 Strategy: a core focus on growth strategy must be the adoption of the target to become a world leader in digitalisation by 2030, building on the Scottish Government's Digital Strategy. A report by Deloitte for the Scottish Futures Trust suggests this could deliver £13 billion to GDP, 175,000 jobs, £2.5 billion in exports and £4.5 billion in tax revenues. The Scottish Futures Trust should be asked to create this strategy immediately identifying the measures required, the role of government and the collaboration needed by the private and other sectors.

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26. Government Led Innovation Review: There should be a policy review to assess the impact of previous interventions and to identify the policy requirements to close the R&D gap, improve the commercialisation performance and identify the role of workplace skills in innovation and the creation of a learning economy. Tax measures such as a Dutch-style R&D tax credit scheme and need for a innovation agency such as Finland's Tekes should both be subject of feasibility studies.

27. Top 5 Strategic Development Projects: at any one point in time we recommend that the Scottish Government, Local Authorities and Economic Development agencies should combine to select the top 5 strategic sites for urgent economic development and devote leadership effort and resource to fast-track them. These are likely to be in or around the main cities where the anticipated return on investment is greatest and likely to unlock greater economic activity. The focus of these projects is likely to combine infrastructure, transport and commercial property and residential development in some

combination. The Infrastructure Commission could lead the process of selection and oversee delivery. Hub airport development and the opportunity for a freight hub could be specific opportunities to investigate further.

28. **Scottish National Investment Bank**: We support the creation of the SNIB and recommend that the bank participates with other investors on long-term risk bearing projects requiring equity investment and return. We further recommend that this policy move is considered alongside a more comprehensive review of policy in this area and the organisations and structures that deliver it from local government to national agencies. Close co-ordination with the British Business Bank and its investment priorities would make sense short, medium and long term as would an equivalent dialogue with the Irish Government.

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The **Sustainable Growth** Commission

Part B
The Framework & Strategy for the Sustainable Public Finances of an Independent Scotland

May 2018

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B1 SCOTLAND'S PUBLIC FINANCES

B1.1 Part B of the report considers the public finances and the governance and strategy required to ensure they are managed sustainably and with credibility, predictability and transparency. It makes recommendations on the strategy to manage them sustainably and put a credible and respected governance framework in place purposefully.

B1.2 This is critically important for any country and especially important for a newly independent country as it transitions to its new governance framework. Those who are required to contribute, or manage, taxation revenues deserve as much foresight and insight on what they will be asked to pay and how. And, of course, the providers of debt finance to sovereigns require comfort that contractual commitments made to them will be honoured and underpinned by credible long-term governance and policy.

B1.3 For the purposes of our analysis we have chosen a particular year, commencing 2021-22, as this is the end of the current planning horizon. This should, in no way, be taken as a target date for an independent Scotland. The decision on when to hold an independence referendum is clearly not one for the Commission. However, choosing a specific year aids the analysis as it allows illustrative numbers to be used. . The choice of starting point is not relevant for the overall approach.

B1.4 The analysis then examines governance examples and experience from our benchmark group of small advanced economies around the world and makes a series of recommendations for the consideration of the First Minister.

B1.5 Clearly the policies undertaken by any independent Scottish Government will depend on the choices made by the electorate in choosing their government. What the Commission's work seeks to do is provide a framework against which future choices may be made, especially through the first five to ten years of transition.

B1.6 Whatever it inherits financially on day one of independence it is critical that the Scottish Government moves purposefully to establish credibility and stability in the public finances as it will, for the first time, be going directly to debt markets to seek funding.

B1.7 As things stand this will require a clear strategy to get the inherited deficit to manageable levels, in an orderly fashion, over a period of time that is sensible. It will also require a clear policy for the on-going containment of debt. Getting this right is one of the core pillars of creating the success of the newly independent country and its economy and the living standards its citizens enjoy.

B1.8 In managing this transition, it is also important that the Scottish Government is careful about the role of public finance policy in stewarding and contributing to the broader economic performance of the country. We can observe from the policy performance of the UK Government in recent years that there is a risk that a counter-productive impact on growth can result from mistimed or poorly considered budget choices. It is a truth that bears

repeating that managing the public finances is not a zero-sum game of taxation and spending. The critical underpinning is the health of the economy and tax base. The health of the economy over the longer term should be uppermost in the minds of policymakers when making decisions about the budget in the short term and in determining the best course for fiscal sustainability.

B1.9 That is not to say that there is any easy route to fixing the public finances from the current model from which they are inherited, there is not. But there is material value – as the evidence from the small advanced economies demonstrates – from tailoring policies to the Scottish economic interest while purposefully securing the credibility we require in creating a sustainable base for the public finances.

B1.10 The recommendations set out in this part of the report do not rely on increasing the growth rate. However, there is no doubt that increasing the long term rate of growth would make the task of fixing the public finances considerably easier. Realising the ambitions set out in part A of this report would mean that the targets set in part B would be achieved earlier and a wider range of options would be available for longer term fiscal management.

The Politics of Scotland's Public Finances

B1.11 The politics of this debate have dominated Scottish political discourse for many decades. The motivation for this is clear but not relevant for the purposes of this report. In fact the existence of the Government Expenditure and Revenue in Scotland (GERS) report provides a helpful starting point for our analysis, giving a greater degree of information and transparency that might otherwise be missing. GERS of course allocates revenues and spending according to the accounting conventions of the central government, not necessarily where they actually arise as would happen under the UN or Eurostat convention on national accounts. Thus, given these assumptions and the lack of discrete data on Scotland, the GERS analysis can only be an estimate of Scotland's position that reflects the current constitutional situation. What we can observe from the performance of the Office for Budget Responsibility and the UK Treasury is that forecasting public finances, and the economy, is difficult. This is true of all countries of course.

B1.12 Therefore, for our purposes in this report we use the latest Government Expenditure and Revenue Scotland 2016-17[1] as our starting point and project this forward leaning where we can on independent analyses such as the Institute for Fiscal Studies, John McLaren's Scottish Trends[2] and the Fraser of Allander Institute.

B1.13 This should ensure that the initial assessment of the 'starting point' is non-controversial. We then make proposals for policy that would not be dependent on any one growth outcome although, obviously, the better the growth performance the better the public finances.

[1] The Scottish Government (August 2017), Government Expenditure and Revenue Scotland 2016-17

[2] John McLaren (March 2017), Scottish Trends: Analysis of key economic and fiscal issues impacting on a 2nd Scottish independence referendum

B1.14 What is undoubtedly true is that the current position of the country's public finances is an imperative for change rather than staying the same. And it is a reflection of the policies and structures that have created the scale of the deficit as it stands, rather than on those that would seek to put it right. And, of course, this analysis can make no assumption about the ability of the Scottish Government to tailor policies to secure faster growth and therefore, reduce the deficit.

B1.15 In political terms, we present a choice for making Scotland's public finances sustainable, purposefully and by our own efforts. It is for others to then judge whether this is preferable to having them ordered in the same manner that got us to the current position in the first place.

B1.16 In addition, the prospect of an extreme Brexit, with Scotland out of the EU and Single Market as part of the UK, is almost certain to make the situation worse, with tax revenues depressed and the very real possibility of a falling working population.

B1.17 Given the nature of Scotland's economy, society and geography there is no doubt that the challenges facing the country are distinct from many parts of the rest of the UK. Economies that are resource rich with a large landmass and a relatively small population should be able to steward their resources in a way that secures sustainable revenue sources.

B1.18 At the same time the delivery of public services can be more expensive than in smaller urbanised geographies. Moreover, the price that Scotland continues to pay for the disorderly management of its post war industrial 'transition' provides an imperative for social policy cohesion and a focus on improving economic participation as we note in Part A.

B1.19 The opportunity in all of this, for a Scotland with the fuller powers of an independent country, is that it can purposefully address its challenges while taking far greater benefit from its opportunities. Culturally, having rounded responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all.

B1.20 Finally, a word on North Sea Revenues: Like the deficit discussion the debate on North Sea Revenues has been framed negatively over the last forty years and more to the detriment of its effective stewardship. It has long been SNP policy to establish a Fund for Future Generations. Successive UK Governments have failed to do this. Looking forward it is our judgement that windfalls such as those that occur from the depletion of scarce natural resources should be treated as windfalls and not depended upon for recurring annual commitments. We have proceeded on this basis. Recent investments in the North Sea and the recovery in oil prices suggest an independent Scotland should be able to reap the long-term benefits of oil revenues for many years to come if they are stewarded sensibly.

B1.21 Taken together this report should give everyone considering the future of Scotland and its public finances a sense of confidence that the country has both the imperative and wherewithal to manage itself with far greater ambition and sustainability than it has been

over the last few decades. How we collectively choose to equip ourselves to achieve this is a separate debate. That this is doable and must be done, should be beyond doubt.

B1.22 Accepting responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all. While this report considers the public finances of an independent Scotland, it is not inconceivable that many of the positive recommendations detailed here could be implemented in advance of such a move.

B2 ANNUAL SOLIDARITY PAYMENT

- An agreement should be sought for a mechanism for Scotland to pay a reasonable share of the servicing of the net balance of UK debt and assets.
- This same mechanism could also include payment for continuing shared services and co-operation for example in the area of international aid for a limited or extended period.
- We strongly recommend that the tone and approach of Scotland to the rest of the UK in those discussions should be informed by the recent and on-going difficulties created by the UK Government's approach to Brexit negotiations.
- Our goal in advance of any independence choice and beyond should be to maintain a relationship that is respectful and as close and positive as between any countries anywhere.

B2.1 Before we introduce the detail of the report we make an initial recommendation for policy that will set an appropriate framework for managing some of the more important negotiation points and transitions to follow. The tone set by Scotland to the rest of the United Kingdom must be positive, responsible and respectful of the fact that we are the party that is changing the arrangements.

B2.2 It will be in the interests of the UK Government and the Scottish Government to pursue an orderly period of negotiation and transition with a view to safeguarding the national self-interest of both.

B2.3 If a positive approach is taken some services could continue to be contracted from shared institutions for a transitional or extended period. The most obvious of these in the immediate short term is International Aid. Scotland will wish to fulfil its United Nations obligation to pay 0.7 per cent of its Gross National Income in foreign aid. In order to provide certainty for some aid recipients it may therefore be favourable to both governments for Scotland to meet its obligations via a funding of UK programmes for a transitional or, indeed, an extended period.

B2.4 Similarly, while it is clear that there is no obligation to do so, we recommend Scotland could and should choose to make a contribution to the servicing of historic UK debt as part of its demonstration of an appropriate approach without prejudicing the outcome of the negotiations.

B2.5 As we discuss in the next section the UK Government's position on this was made clear in January 2014: "a share of the outstanding stock of debt instruments that have been issued by the UK Government would not be transferred to Scotland"[3]. By definition this means that an independent Scotland would start with zero debt. However we recommend that a fair and proportionate division of assets and liabilities should be negotiated. The UK

[3] HM Treasury (January 2014), UK debt and the Scotland independence referendum

Government made clear that such a division of assets and liabilities would be negotiated with the Scottish Government and a contract agreed.

B2.6 The Commission therefore recommends that, in the event of independence, a new Annual Solidarity Payment should be agreed. The level of this must be subject to an analysis of assets and liabilities at the point of independence and respective fair and proportionate shares.

B2.7 We do not as yet know the negotiated outcome but we anticipate that it would mean a payment by Scotland to the UK Government to finance on-going shared services, and to meet an agreed share of debt-servicing costs. We provide an initial estimate in the sections to follow for planning purposes but obviously without seeking to prejudice the outcome of any such negotiations.

B2.8 The existence of this payment we hope sets a tone of respect and good order towards the rest of the United Kingdom with which, we anticipate, an on-going relationship that is as strong, positive and productive as between any two independent countries.

B2.9 Such an approach would be our recommendation in any context but is especially thrown into focus by some initial lessons learned from the less than orderly approach to the Brexit discussions so far.

B3 PUBLIC FINANCES: ASSETS & LIABILITIES

- The sustainable management of national debt is mission critical to the UK, as it is to any country. Scotland is no different. Any sustainable government policy should be informed by an appreciation of the assets and liabilities passed to future generations.
- Data is available from the UK government on assets and liabilities held by the public sector across the UK. Scotland's per capita share of the UK's non-current assets was £115 billion in 2015-16. After taking account of assets already located in Scotland and (non-pension) liabilities, there would be a net positive balance of £26 billion.
- The fair and equitable division of these assets and liabilities will be the subject of agreement in the event of a positive independence choice. The UK Treasury confirmed in 2014 that existing UK debt instruments remain the responsibility of the continuing UK Government. The UK's debt will therefore remain the responsibility of the UK Government after Scotland becomes independent. By definition, an independent Scotland will start with zero debt. The strength of that position should not be underestimated. However, an independent Scotland could choose to agree to contribute to the servicing costs of a fair and reasonable share of UK debt (net of a share of assets).
- A negotiated balance to be serviced by the Scottish Government should take account of the balance of assets and liabilities as the UK currently argues in its negotiations with the European Union. We recommend a balance is paid annually to service UK debt instruments and set out our assumptions based on the data we have available. However, we would expect the true value of assets and liabilities to be examined and debated with greater rigour in advance of agreement being reached.
- For the purposes of our report we take a conservative estimate based on OBR projections and the balances noted, and assume an annual debt servicing charge of £3.0 billion (1.6% of GDP in 2021-22.) However this will fall as a percentage of GDP over time, as a result of inflation and economic growth.

B3.1 The focus of the public finance debate in Scotland tends to be on the annual levels of taxation and spending and the net fiscal balance - that is, whether Scotland's public finances are in surplus or deficit, and how that compares with UK public finances.

B3.2 However, there is also the balance sheet to consider, the assets and liabilities of the Government. This "stock" position is arguably more important than the "flow" of the deficit but the latter can quickly undermine the former. We judge that a focus on this is material to the effective stewardship of public resources. The unfunded or underfunded nature of many of the UK's liabilities we judge to be injudicious and imprudent (although this is not unique to the UK). At the same time an effective understanding of the assets side of the balance sheet allows for a true sense of the sustainable financial health of the public finances and for choices to be made that may enhance this. What is true for the smallest company is true for any country. We return to this in section B11 where we learn the lessons from other small

advanced economies and make recommendations for the policy of the Scottish Government.

B3.3 In this section we consider the issue of the inherited and transferred assets and liabilities that would come under the responsibility of the Scottish Government. The first of these is the highest profile, the UK National Debt.

Context on UK Debt

B3.4 The terms 'debt' and 'deficit' are sometimes confused and conflated in political debate and, while related, they refer to different things.

B3.5 A public sector deficit is where government spending is higher than the total revenues collected from taxation in any given year. In these circumstances, it is necessary for the Government to borrow to cover the deficit. This is the 'flow' that adds to (or in a period of surplus subtracts) from the stock of historic debt.

B3.6 Public sector debt (or government debt) is the cumulation of past deficits that build up over time, when a Government regularly runs deficits and must borrow. Measures of debt include gross government debt (which includes all government debt) and net government debt (gross debt minus liquid assets).

B3.7 Both deficit and debt figures are sometimes expressed in absolute terms, and sometimes as a percentage of economic output (GDP) to show the burden placed on the economy because the debt ratio reflects the capacity to sustain such a level of debt. This provides a basis for making comparisons between countries and to get a sense of sustainability.

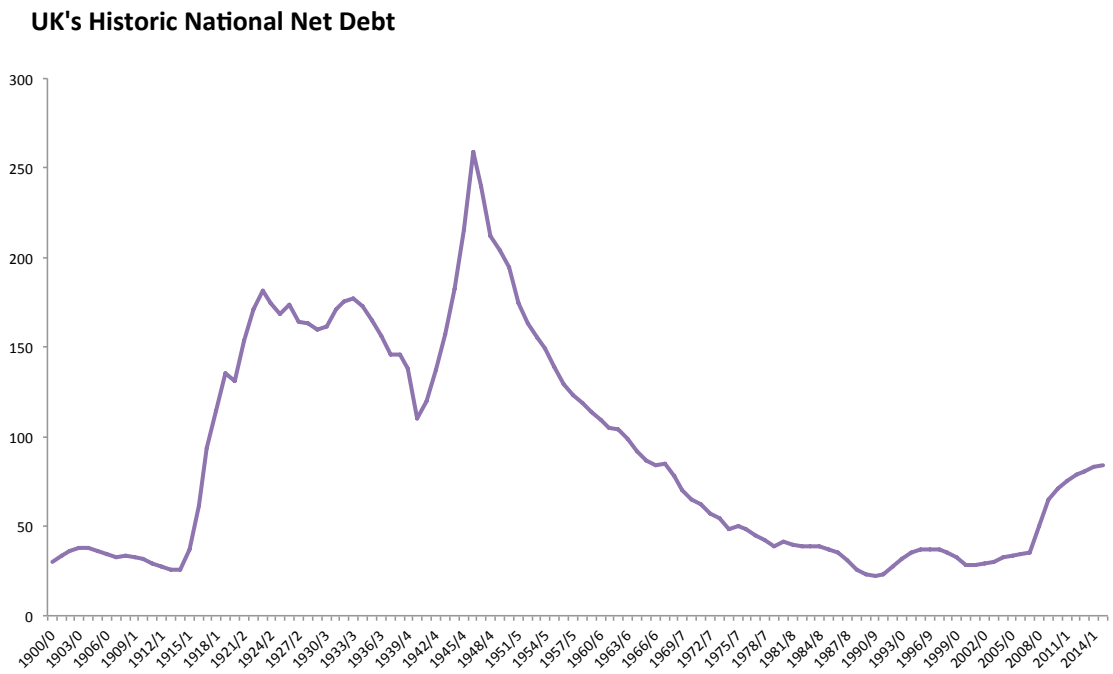
Historic

B3.8 At the end of the 2016-17 fiscal year, net government debt in the UK was £1.7 trillion, (equivalent to 86% of GDP), around 14 times the cash value of debt in 1980-81[4]. This does not take account of inflation or economic growth over time. But an analysis of debt as a proportion of GDP does. The ratio of the UK's government debt to GDP is higher now than it has been since the 1970s but less than in the aftermath of the World Wars and Great Depression (Figure 3-1). It is significantly ahead of the 60% target ratio generally considered to be the sustainable level.

B3.9 Debt that has arisen from deficit funding can reach a point where it is unsustainable. However, debt associated with investment is different (and seen as such by financial markets) since it generates future revenues and growth to service that debt.

[4] Office for Budget Responsibility (November 2017), Economic and fiscal outlook

Figure 3-1 – UK Historic Debt (as % GDP)



Source: House of Commons Library (Briefing Paper Number 05745)

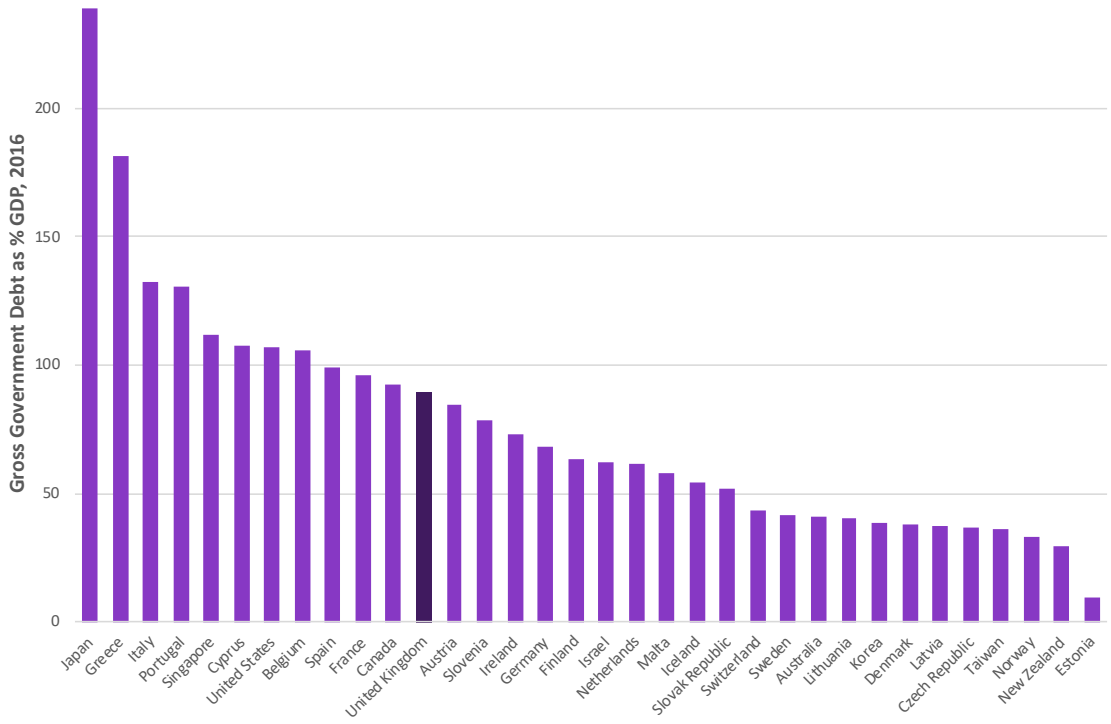
B3.10 UK debt is forecast to be more than £1.8 trillion by the early 2020s, equivalent to almost 80% of GDP. However, this includes approximately £400 billion of debt that, because of Quantitative Easing (QE), the Government now owes to itself, thereby reducing the net costs of debt servicing.

B3.11 The sustainability of government debt levels depends on many factors, not least the cost of servicing the debt. In the 1980s, the UK was paying debt interest in the range of 9% to 13% and as a result debt interest payments accounted for a very large proportion of public spending, typically around 10%. This was still as high as 7% to 8% of public spending in the 1990s. Current interest rates are much lower, meaning the cost of servicing current levels of debt now account for less than 5% of public spending.

Comparators

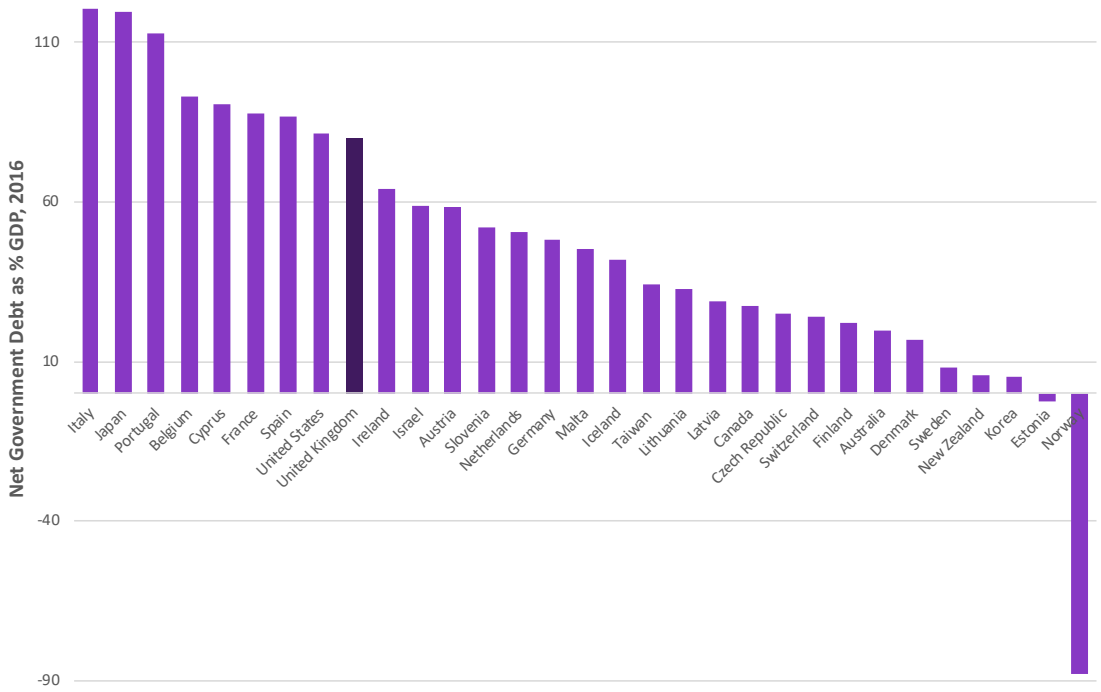
B3.12 The UK's gross debt means that it is in the top half of most indebted advanced economies, but there are some with considerably higher levels, such as Japan and Italy. Other advanced economies with higher levels of gross debt than the UK include the United States, Spain, France and Canada (Figure 3-2). Similarly, in net debt terms (which nets off government financial assets from gross debt), the UK has higher levels of indebtedness than most advanced economies, but less than the United States, Spain and France (Figure 3-3).

Figure 3-2 – Gross Government Debt in Advanced Economies, 2016



Source: IMF World Economic Outlook Database, October 2017

Figure 3-3 – Net Government Debt in Advanced Economies, 2016



Source: IMF World Economic Outlook Database, October 2017

Debt and Economic Growth

B3.13 Increasing absolute levels of government debt can be sustainable, so long as spending made possible by the borrowing generates economic growth to the point of reducing the debt/GDP ratio. If the outcome of increasing borrowing is higher economic growth than would otherwise have been achieved, and if taxation revenues associated with that additional economic growth exceed the extra interest payments on debt, the additional borrowing will improve the public finances.

B3.14 For example, consider an economy where total output (i.e. adding all goods and services produced) is around £150 billion per year and the public sector, measured in terms of tax collected, accounts for around 40% (£60 billion). If the Government borrowed £10 billion at a 2% interest rate, it would be necessary to find £200 million per year to pay interest on the borrowing. Growing that economy by just 0.33% (one third of one percent) would add £500 million to the economy, which would be associated with around £200 million in additional tax revenues - enough to meet the interest on the additional debt.

B3.15 All of that said, the debt contract remains fixed while the performance of the economy varies. It is therefore the policy of most small advanced economies that we have examined to get the debt position under control and to sustainable levels and we return to this in our policy recommendations.

Context on UK Assets

B3.16 The Whole of Government Accounts[5] sets out details of government spending and tax revenues as well as other financial details such as the assets and liabilities of the public sector in the UK. This national balance sheet includes all central government departments, agencies, local government and other government bodies (including the Bank of England). The latest year for which figures are available is 2015-16.

B3.17 Each government department also publishes accounts that set out assets and liabilities. This includes the Scottish Government[6], Scottish local government and other public agencies associated with devolved government in Scotland. The accuracy of these valuations has not been scrutinised in any detail or been the subject of much public debate. But they provide a useful initial framework for the purposes of this report.

B3.18 During the 2014 Referendum, the Chartered Institute of Public Finance and Accountancy (CIPFA) published an analysis of Scotland's public sector finances[7], including estimates of assets and liabilities. Based on 2012-13, CIPFA estimated total assets held by devolved Scottish government and local government at £84.4 billion. Between 2012-13 and 2015-16, Scottish Government and Scottish local government assets increased in nominal terms

[5] HM Treasury (July 2017), Whole of Government Accounts 2015-16
[6] Scottish Government (September 2016), Scottish Government Consolidated Accounts 2015-16
[7] CIPFA (2014, Scotland's Future in the Balance

by approximately 7%[8], and so updating the CIPFA estimate to 2015-16 would give a total of around £90 billion for public sector assets already held in Scotland.

B3.19 In 2015-16, the value of UK non-current assets was given as £1.39 trillion (Table 3-1). Scotland's per capita share of those assets would be £116.5 billion. So if assets already associated with the Scottish Government and its agencies (and local government in Scotland) were valued at £90 billion, this would imply that Scotland would reasonably expect, in addition to assets already held, a share of UK Government assets of £26 billion[9].

B3.20 Given that many of the UK assets are fixed assets than cannot be easily or quickly converted into liquid assets, it is more likely that this net asset share would be set against a Scottish share of liabilities, such as past debt.

Table 3-1 – UK Assets (£ billion)

Non-Current Assets	UK Total
Property, plant & equipment	1,120
Investment property	16
Intangible assets	33
Trade & other receivables	14
Other financial assets	209
Total Non-Current Assets	1,392
Scottish Per Capita Share	116
Scottish Government, Agencies & Local Government Associated Assets	90
Additional Scottish Per Capita Share	26

Source: Whole of Government Accounts & Scottish Government Consolidated Accounts 2015-16

UK Liabilities

B3.21 In 2015-16, UK liabilities were put at £3.73 trillion more than three-quarters of which were non-current liabilities (not due within a year). This includes net government borrowing & financing of £1,261 billion and net unfunded and underfunded public sector pension liabilities of £1,425 billion.

[8] Sources: Scottish Government Consolidated Accounts 2012-13 and 2015-16, Scottish Local Government Financial Statistics 2012-13 and 2015-16

[9] This could be an underestimate since if identifiable Scottish assets and identifiable assets from other UK nations (e.g. those of local government outwith Scotland and of NHS England), are deducted from the total UK assets and then apportioned on a per capita basis, the Scottish share of UK could be as much as £100 billion. However, for the purposes of this report, we have used the conservative assumption of just £26 billion.

B3.22 The liabilities set out in the Whole of Government Accounts are based on international accounting standards and are for net public sector debt. So, this excludes the debt that the UK Government owes to itself, due to Quantitative Easing, QE, of around £350 billion[10].

B3.23 The pension liabilities are for public sector pensions only and do not include future state pension liabilities. This is because, unlike public sector workers who have accrued their pension entitlement during the period of employment, citizens are entitled only to a payment under the state pension scheme if they meet certain criteria on the date that payment would be due. The Whole of Government Accounts therefore includes state pension payments as current expenditure but not as a liability in the balance sheet.

B3.24 The unfunded state pension commitments do emphasise the importance of addressing Scotland's demographic trends, as outlined in Part A, chapter A4, The Imperative of Population Growth.

B3.25 Scotland's per capita share of those liabilities would be circa £311.2 billion. This would include net government borrowing & financing of £105.8 billion, net unfunded and underfunded public sector pension liabilities of £118.3 billion.

B3.26 Excluding the significant items of government debt and underfunded public sector pensions, the Whole of Government Accounts also include non-current liabilities of £187 billion. A per capita share of this for Scotland would be approximately £15 billion. However, this is approximate to the £15 billion non-debt and public sector pension liabilities already associated with devolved government in Scotland, as identified in the CIPFA analysis.

Scotland's "Fair and Appropriate" Share of Assets and Liabilities

B3.27 The Whole of Government Accounts that contain the estimates of UK assets and liabilities cover all UK government departments and agencies, including devolved governments and so the UK figures already include the Scottish public sector assets and liabilities.

B3.28 The distribution of assets and liabilities should Scotland chose to become independent would be a matter for negotiation.

Public Sector Pension Liabilities

B3.29 Any historic public sector pension liabilities would be the responsibility of the government that made the commitments to retired and current employees, i.e. the UK Government.

[10] It is recognised that at some point in the future the decision may be taken to reverse QE and that this could be done by the Bank of England selling the bonds it holds on the open market, with implications for monetary policy. However, the purpose of this analysis is to calculate a share that Scotland may agree to contribute to on-going UK Government debt servicing costs post-independence and so in that context, the stock of debt net of QE is the relevant basis for the calculation since it is this net debt that has servicing costs.

However, it is likely that the UK Government may wish to transfer the liability to the Scottish Government, as part of a wider agreement and that the Scottish Government would wish to accept. An orderly negotiation is in the direct interest of both parties and would be expected. The costs of this liability to an independent Scottish Government have been included in the expenditure projections presented in this report.

Government Debt

B3.30 Based on the 2015-16 Whole of Government Accounts, UK Government borrowing was £1,261 billion. Scotland's per capita share of this would be £106 billion. However, the OBR is projecting that UK net debt will increase to £1,841 billion[11] by 2021-22. This includes debt that relates to QE and means that no interest needs to be paid (or more precisely that the interest is paid to one part of government by another part of government) and so there is no effect on the public sector balance. The OBR projections for interest payments are for gross payments of £52.4 billion and net payments of £46.6 billion in 2021-22. Scotland's per capita share of these net payments would be £3.8 billion equivalent to 2.0% of projected GDP.

B3.31 As HM Treasury recognised in January 2014 (Figure 3-4), the UK's national debt is a matter for the UK in the event of Scotland becoming independent and cannot be assigned to another government. The holders of the debt have a contract with the UK Government that is not transferable. So, if Scotland did agree to take responsibility for a share of UK debt, the debt itself could not be transferred. It would be subject to an agreement to pay an annual amount to the UK Government for an agreed period as a way of contributing to debt-servicing costs.

B3.32 This debt would still formally be UK Government debt, since it would be existing non-transferrable debt, but would be the basis on which Scotland would agree to contribute to debt interest payments.

[11] Office for Budget Responsibility (March 2018), Economic & Fiscal Outlook

Figure 3-4 – UK Government on UK Debt Liability

UK debt and the Scotland independence referendum

The transfer of debt

1.1 In the event of Scottish independence from the United Kingdom (UK), the continuing UK Government would in all circumstances honour the contractual terms of the debt issued by the UK Government. An independent Scottish state would become responsible for a fair and proportionate share of the UK's current liabilities, but a share of the outstanding stock of debt instruments that have been issued by the UK would not be transferred to Scotland. For example, there would be no change in counterparty for holders of UK gilts. Instead, an independent Scotland would need to raise funds in order to reimburse the continuing UK for this share.

1.2 An entirely separate contract between the continuing UK Government and an independent Scottish state's Government would need to be established. The respective shares of debt and the terms of repayment would be subject to negotiation.

1.3 In the event of independence, the full spectrum of assets and liabilities – past, future and contingent – would need to be considered in negotiations between the continuing UK and Scottish Governments, on a case-by-case basis. This means that the negotiations would need to cover the arrangements for all forms of debt covered in this note, not just gilts and Treasury bills.

Source: HMT (January 2014)

B3.33 As a result, the inherited debt position of an independent Scotland would be 0% of GDP. However, we also assume that credit markets will consider the impact of the Annual Solidarity Payment when assessing Scotland's creditworthiness. The net position of almost £90 billion (after accounting for a share of assets) would be the basis for calculating a reasonable contribution to legacy debt servicing costs and it should be noted that this legacy ratio will fall over time as the economy grows and as a result of inflation.

B3.34 At the projected costs of servicing UK debt in 2021-22 (2.83%[12]) the annual cost of debt interest would be £3.0 billion, which represents 1.6% of Scottish GDP. To put this another way, netting off a proportionate share of assets would reduce Scotland's share of debt by almost a quarter, based on the best information currently available, reducing debt servicing costs from 2.0% to 1.6% of GDP.

B3.35 Of course this sum would be subject to negotiation and agreement but we provide it as an initial estimate based on the best information available to us. This is not an unreasonable assessment of "Fair and Proportionate" but nor should it prejudice any future negotiation as the exact detail of asset valuation in particular should be subject to detailed and independent scrutiny.

[12] Office for Budget Responsibility (March 2017), Economic & Fiscal Outlook projects total UK spending on debt interest payments of £52.4 billion in 2021-22 and debt of £1,841 billion, giving an effective interest rate of 2.83%

B4 UNDERSTANDING SCOTLAND'S INHERITED FISCAL POSITION

- The existing Government Expenditure and Revenue reports for Scotland estimates Scotland's position within the UK. That is our starting point for analysis. The latest report for 2016-17 identifies a Scottish deficit of 8.3% of GDP.
- Taxes raised in Scotland are sufficient at present to fund all devolved services plus welfare and pensions.
- Scotland contributes substantially to UK tax revenues. It is striking to note that, if London and the South East is excluded, Scotland (excluding oil and gas revenues) contributed 12.6% of the revenues, with 11.3% of the population share, in the latest regional tax statistics.
- We assume North Sea revenues at zero for the purposes of our analysis. That does not mean we are anticipating no revenues. In fact recent investment and revenue projections have been positive. Rather, we recommend that windfalls such as from oil are not allocated to current expenditure but are set aside in a Fund for Future Generations, potentially managed through the Scottish National Investment Bank, for investment in inter-generational projects.
- Approximately 40% of government expenditure allocated to Scotland is by the UK Government.
- From 8.3% in the latest estimates it is anticipated on the basis of OBR and other independent forecasts that the GERS estimate of Scotland's deficit would be 7.1% of GDP by 2021-22. This would have to come down. However, it should be noted the UK has had a deficit at or above this level in six of the last ten years.
- In making comparisons between the possible position of an independent Scotland and the position if Scotland was to remain within the UK, policy choices by the UK Government, not least to leave the EU, which will impact on tax revenue and spending, must be considered.
- The current planning period suggests a 6% cut in the Scottish budget by 2020-21 by the UK Government in addition to the 5% real terms cut experienced since 2010.
- The UK Government's intention to leave the EU and European Single Market is expected to lead to slower growth, with substantial downward pressures on spending.
- Scottish Government analysis shows that Brexit could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030 compared to remaining in the EU.
- The Annual Solidarity Payment is modelled at around £5 billion including debt servicing contributions, 0.7% GNP contribution for foreign aid and a further £1bn set aside for other shared services.

- Scotland's replication of UK budget spend currently allocated to Scotland in a number of areas is assumed to be unchanged for our analysis including welfare, pensions, economic development and scientific and university research funding.
- Defence budget assumed at an initial 1.6% GDP, significantly ahead of the small European country average (1.1%) and the 8th highest in NATO. But it represents a saving on UK plans currently allocated to Scotland and presents spending multiplier opportunities for expanding the Scottish economy.
- Two expert reviews are recommended: Comprehensive Review of Inherited UK Spending programmes; Standing Council on Scottish Public Sector Financial Performance.
- We have chosen a specific year, 2021-22, to illustrate the potential starting point of an independent Scotland and a subsequent deficit reduction plan. This should in no way be interpreted as a target date. Rather, choosing a particular year as an illustration allows for realistic forecasts to be made and a better understanding of the choices available.
- As a result of the above analysis we anticipate that in 2021-22 the actual inherited deficit would be, on very conservative assumptions and an acceptance of the GERS analysis, 5.5% of GDP. The difference is explained by the savings from defence (0.4%) and UK central programmes (0.8%) and the impact of net assets/liabilities on the anticipated debt servicing element of the United Kingdom Annual Solidarity Payment (0.4%). This is further adjusted to 5.9% of GDP to exclude North Sea Revenues. This would be the anticipated starting point without any significant policy changes or ambitious growth assumptions.
- This analysis depends on existing UK and Scottish Government published data that will vary over time. However, the direction of travel and broad position detailed should as closely approximate to anticipated reality as any government budget planning can be.

B4.1 The most recent "Government Expenditure and Revenue in Scotland" (GERS) report, for 2015-16[13] included an estimated public sector deficit for Scotland of £13.3 billion in 2016-17, equivalent to 8.3% of GDP.

B4.2 The GERS report is a statistical analysis of taxation raised from Scotland and of government expenditure in and on behalf of Scotland, as a part of the UK. It is not an analysis of what public finances would look like in an independent Scotland. There are two main reasons.

B4.3 Firstly an independent Scottish Government would be expected to make different decisions on taxation and government expenditure.

B4.4 Second as a small advanced economy, Scotland would not require the same public spending that the UK as a large country has chosen to incur. To put it another way, Scotland

[13] Scottish Government (August 2017), Government Expenditure and Revenue in Scotland, 2016-17

would not have the same level of overhead that it is helping to finance as part of the UK and there would be opportunities related to the greater efficiency in government operations that is generally found in small advanced economies.

B4.5 Furthermore, some of the expenditure that has been allocated to Scotland in the GERS analysis is based simply on a per capita allocation rather than whether Scotland's fiscal position contributes to that expenditure. Notably, GERS allocates a population proportion of the UK's debt interest payments to Scotland whereas, as we discussed in chapter B4 this is likely to be the subject of negotiation taking full account of a "fair and proportionate" share of all assets and liabilities.

B4.6 While the GERS publication cannot tell us what might happen to Scottish public sector finances after independence it can provide an initial and helpful insight to assessing what the starting point might be for public finances on Day One of an independent Scotland.

B4.7 For all its conceptual and practical limitations we see very little value in comprehensively challenging the detail of the GERS report; far better to accept its starting analysis and remove the controversy from our deliberations. As with all fiscal projections there is uncertainty. The UK Office for Budget Responsibility (OBR) is laudably transparent about the variations in its forecasts. Between its November 2016 and March 2017 reports it varied the anticipated borrowing requirement in the current year by £16 billion for example. In June 2010, OBR forecast that public sector deficit in 2015-16 would be £17.6 billion (0.9% of GDP), and it turned out to be much larger at £76.5 billion.

B4.8 However the shape of what we come on to analyse and propose demonstrates a framework that can be implemented to provide stability, credibility and certainty. If the outturn proves more favourable the journey to sustainable public finances will be shorter, and vice versa. What must be clear to all affected by Scottish Fiscal Policy is that the intent and purpose of the Scottish Government in implementing this framework is determined and focussed. We come on to recommend a governance framework to secure such an outcome later in the report.

UK and Scottish Public Sector Deficits

B4.9 In 2016-17 total government expenditure associated with Scotland was £71.2 billion. Of that, £42.1 billion was spending by the Scottish Government (and local authorities in Scotland), with a further £29.1 billion of spending by the UK Government allocated to Scotland. Of the total £71.2 billion, £63.2 billion was current spending and £8.0 billion was capital.

B4.10 In 2016-17, total taxation revenues associated with Scotland were £57.8 billion (including £4.3 billion in accounting adjustments).

B4.11 The three taxes associated with the highest proportions of that revenue were income tax at almost £13 billion (24% of taxation revenue excluding accounting adjustments), and National Insurance at over £10 billion (20%) and VAT at just over £10 billion (19%).

B4.12 Table 4-1 displays Scotland's tax revenues as a proportion of the UK's total revenues for individual taxes, based on 2015-16. Scotland generated revenue accounting for just less than its population share (8.1% of revenues for a population share of 8.3%), well within the margin of error for taxation receipt estimates. It is also striking to note that if London and the South East is excluded Scotland contributed 12.6% of the revenues, with 11.3% of the population share.

Table 4-1 – Scotland non-North Sea tax revenues as a proportion of UK tax revenues (2015-16)

	£ million	Scotland as % of UK	Scotland as % of UK (ex L&SE)
Population share	-	8.3%	11.3%
Income tax	12,239	7.2%	12.6%
Capital gains tax	384	5.4%	10.3%
Corporation tax (excl. North Sea)	3,208	7.1%	13.1%
Total Taxes on income and wealth	15,885	7.2%	12.6%
Value added tax	10,838	8.3%	12.2%
Fuel duties	2,356	8.5%	11.0%
Business rates	2,579	9.9%	15.9%
Stamp tax on shares	1,043	9.8%	12.9%
Tobacco duties	86	7.7%	10.0%
Alcohol duties	2,232	9.8%	14.1%
Vehicle excise duties paid by businesses	292	9.6%	21.8%
Air passenger duty	175	9.7%	12.3%
Insurance premium tax	577	12.7%	17.7%
Environmental levies	219	10.2%	12.8%
EU ETS auction receipts	147	14.3%	17.6%
Betting and gaming duty	51	14.7%	16.6%
Total Taxes on production	20,917	8.6%	12.7%
Vehicle excise duties paid by households	380	7.9%	10.5%
TV Licence fees	275	8.8%	11.9%
Council tax	2,115	7.3%	10.4%
Total Other current taxes	3,057	7.4%	10.5%
National Insurance Contributions	9,431	8.3%	12.8%
Total Other current receipts	15,054	8.6%	12.9%
Total current receipts (ex. Oil & Gas rev.)	54,913	8.1%	12.6%

Source: ONS (May 2017), Country and Regional Public Sector Finances Year Ending March 2016

Oil and Gas Revenue

B4.13 Over the last 30 years, oil and gas revenues have made a significant contribution to tax revenues raised in Scotland. Oil and gas revenues were as high as £9.6 billion in 2011-12

(17% of total taxation revenues that year) and since 1999, the average has been £5.5 billion (an average of 12% of total taxation revenues). By 2015-16 oil and gas revenues had fallen to £0.06 billion (£60 million), from £1.8 billion in 2014-15 and £4 billion in 2013-14. In 2016-17, there was some recovery in revenues at £208 million.

B4.14 Scotland's fiscal position has dipped because of this fall in oil and gas taxation revenues. However, a large part of the gap has been closed by increases in tax receipts associated with the onshore economy, with revenues increasing by around £6.7 billion over a three-year period (an increase of almost 15%), including an annual 6.5% increase in 2016-17.

B4.15 Much political commentary has associated declining tax revenues from oil and gas with a fall in the oil price. However, published statistics[14] on the oil and gas sector show that tax revenues accounted for 28% of total income in 2011-12 (£34.6 billion in income and £9.6 billion in tax revenues), but this had fallen to 8% of income in 2014-15 (income of £21.2 billion and tax revenues of £1.8 billion) and 0.4% of income in 2015-16 (income of £16.1 billion and tax revenues if £60 million). This is to be expected given that the profits which are taxed will have fallen by more than revenues. However, the UK's oil and gas tax receipts have also fallen due to policy decisions taken by the UK Government on the taxation of the sector, for example on tax rates (including setting the rate of petroleum revenue tax at zero in March 2016[15]) and tax allowances associated with investment.

B4.16 During the downturn in oil prices, investment has been decreasing (£14 billion in 2014-15 and £11 billion in 2015-16) but from a level that is much higher than earlier in the 2000s. Combined with the focus of the UK sector on reducing production costs and increasing innovation, it is more likely that production levels will stabilise or even increase (as they did in 2016-17). The Oil and Gas Authority's October 2016 projection[16] has production stabilising in the five-year period to 2021 (in volume terms) at a slightly higher level than recent production. What this will mean for taxation revenues will depend on oil prices (or, more specifically the profitability of production), and on the taxation regime in place.

B4.17 If tax revenues from oil and gas do recover, using such revenues for current spending - as the UK Government has done over the last four decades - cannot be judged a prudent or judicious use of a windfall from the depletion of a scarce natural resource.

Scottish Government Spending

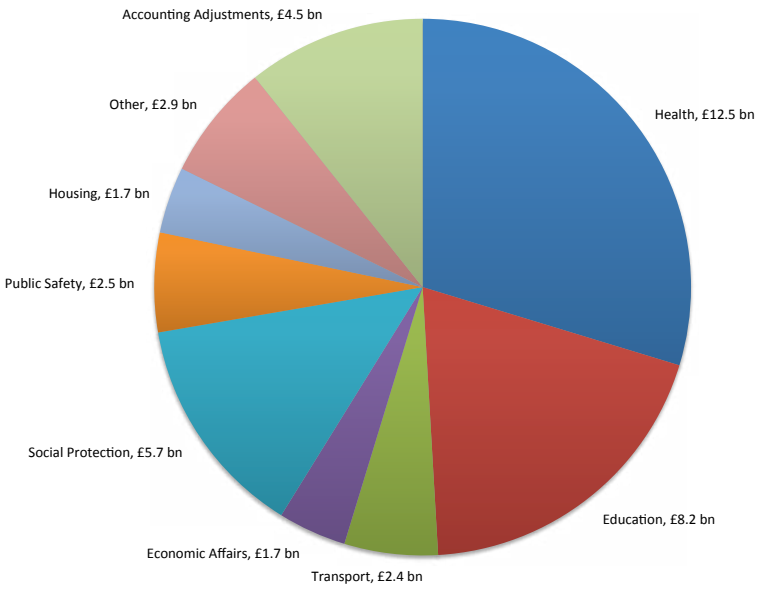
B4.18 Of the total £71.2 billion government spending associated with Scotland, £42.1 billion is spending by the Scottish Government (including Scottish local authorities). Almost half of this is accounted for by health and education spending (Figure 4-1).

[14] Scottish Government (September 2016), Oil and Gas Production Statistics 2015-16

[15] HM Revenue & Customs (March 2016), Oil and gas taxation: reduction in Petroleum Revenue Tax and supplementary charge

[16] Oil and Gas Authority (October 2016), UKCS Oil and Gas Production Projections

Figure 4-1 – Scottish Government (and Local Authority) Spending 2016-17 (Total £42.1 Billion)



Source: GERS, 2016-17

B4.19 The funding regime that has been in place for the Scottish Parliament has, until recently, been based on a system where most funding was provided via a block grant from the UK Government. The recent real terms cuts in the Scottish Budget and the further real terms cut in resource budgets expected by 2020-21, have meant that savings in these budgets needed to be found, and will continue to be necessary.

B4.20 In this context, planning for additional cuts over and above those already planned is likely to be counter-productive, since much of this spending provides the conditions necessary for economic growth, including high quality health and education systems.

B4.21 However, this is not to say there should no focus on improving the quantity and quality of the outputs and outcomes from this spending. Indeed, the focus of the sustainable economic growth proposals set out in subsequent reports on improving productivity levels and this strategic effort should apply to the public as well as the private sector.

B4.22 There is no shortage of ideas for improving public services funded from the Scottish Government's budget. Reviews commissioned by the Scottish Government itself include the Independent Budget Review[17] in 2010 and the Christie Commission[18] in 2011. The priorities and recommendations of the Christie Commission remain valid. They include the design of services based on the needs of people and communities (rather than the service providers), breaking down barriers between departments and agencies and integrating

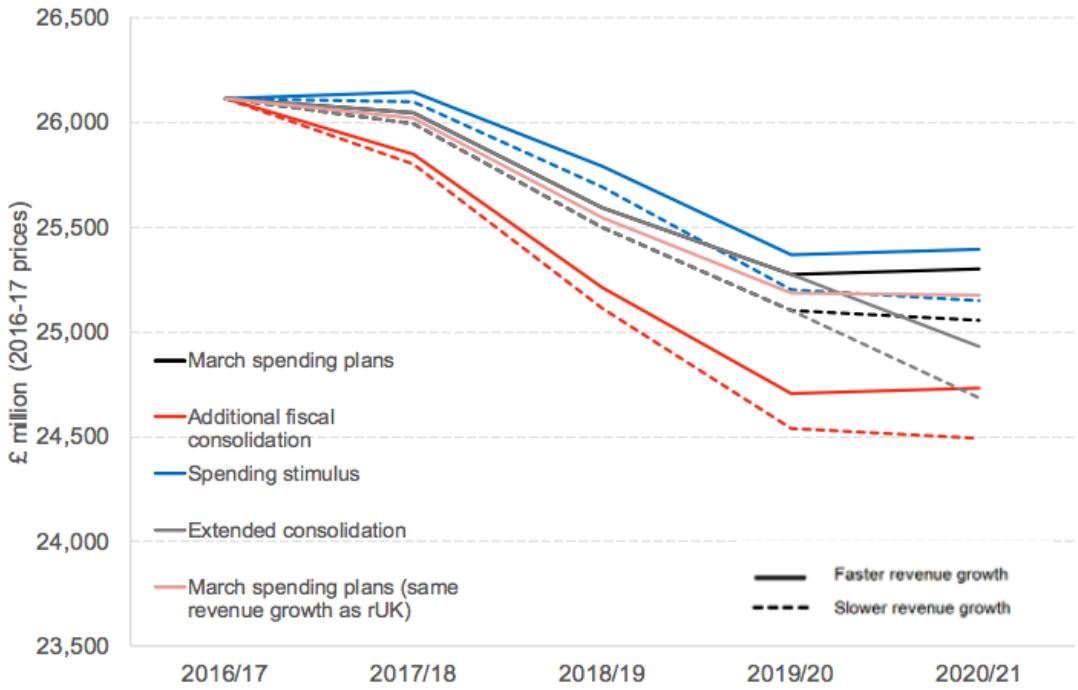
[17] Crawford Beveridge, Sir Neil McIntosh & Robert Wilson (July 2010), The Report of Scotland's Independent Budget Review Panel

[18] Commission On The Future Delivery Of Public Services (2011), "The Christie Commission"

services, building resilience, prioritising preventative measures, focusing on outcomes and creating more efficiency.

B4.23 Analysis by the Fraser of Allander Institute[19] finds that the Scottish Budget in 2016-17 was 5% lower in real terms than in 2010-11, with capital spending down by 12% in real terms. In the period to 2020-21, the Institute suggests that the Scottish Budget could be cut by a further 3-4% and possibly up to 6%. Cuts of that scale would be more than the entire budgets for the Finance and Economy; Fair Work, Skills and Training; Culture and External Affairs; and Rural Affairs, Food and Environment portfolios combined.

Figure 4-2 – Scottish Budget Scenarios to 2020-21



Source: Fraser of Allander Institute, Scotland's Budget 2016

B4.24 The UK Government's intention to leave the EU and European Single Market is expected to lead to lower growth, with substantial downward pressure on spending. Scottish Government analysis shows that Brexit could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030 compared to remaining in the EU. Whatever the challenges and opportunities associated with independence, it is clear that the status quo is not a no risk option, quite the reverse.

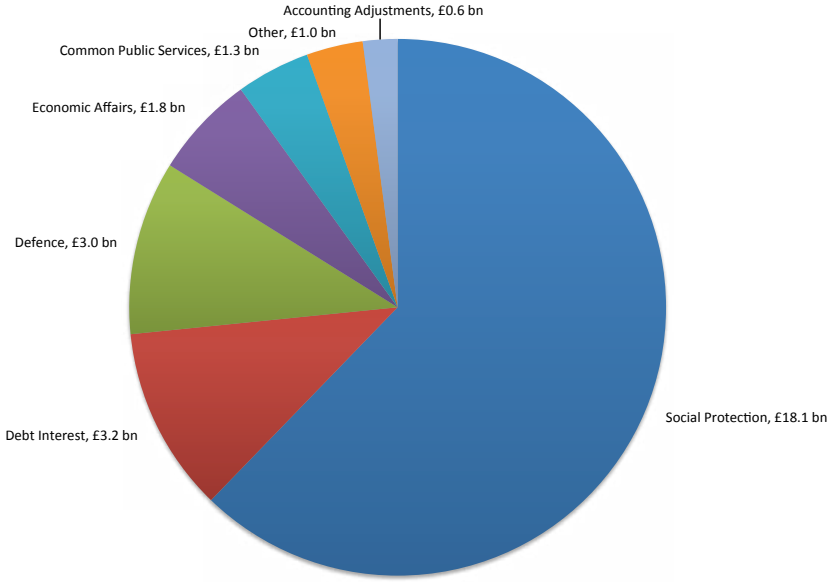
UK Government Spending Allocated to Scotland

B4.25 More than 40% of government expenditure in and on behalf of Scotland is spending by the UK Government, some £29.1 billion per year (Figure 4-3). The largest share of this goes

[19] Fraser of Allander Institute (September 2016), Scotland's Budget

towards social protection, which includes pensions, unemployment benefit and other welfare payments - a total of more than £18 billion per year.

Figure 4-3 – UK Government Spending Allocated to Scotland 2016-17 (Total £29.1 Billion)



Source: GERS, 2016-17

B4.26 The rest of the expenditure allocated to Scotland is based on actual spending in the few cases where UK Government accounting allows this to be identified. For example, the economic affairs category includes science and technology, where Scotland receives a higher than capita share of the budget, due to its internationally competitive university sector.

B4.27 However, for most categories, the spending is not in Scotland and is simply an allocation, usually on a per capita basis that is designated to be for the benefit of the UK overall, including Scotland. This includes defence, foreign affairs, international aid and other common services spending associated with the administration of the UK Government.

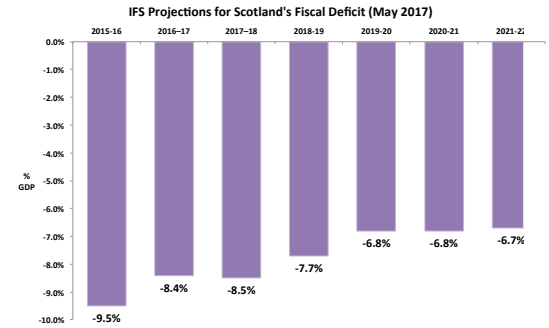
B4.28 This allocated expenditure raises interesting implications for an independent Scotland, since it is not spending that Scotland would be committed to, unless decisions were made to either contribute to UK Government spending on an interim basis (for example, as part of a shared services agreement in areas such as international aid discussed above) or to replicate services currently provided by the UK Government for the UK overall.

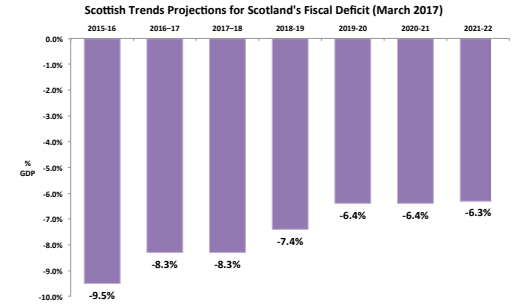
Scotland's Fiscal Deficit – within the UK

B4.29 Scotland's fiscal deficit, as reported in GERS for 2016-17 was equivalent to 8.3% of GDP[20]. Based on current forecasts for the UK fiscal deficit from the OBR, that is predicted to fall to 6-7% of GDP by the early 2020s.

B4.30 In March 2017, in Scottish Trends, the former Civil Service Economist and then Coalition Government special adviser John McLaren projected a deficit of 6.3% of GDP for 2021-22 and in May 2017, the Institute for Fiscal Studies projected a fiscal deficit for Scotland of 6.7% of GDP in 2021-22. Whilst these pre-dated the latest GERS report, the forecasts for 2016-17 were close to the actual outturn of 8.3% (exactly in line in the case of John McLaren).

Figure 4-4 – Scotland's Fiscal Starting Point (IFS)





Source: IFS (May 2017) & Source: Scottish Trends (March 2017)

B4.31 These projections were also made in advance of the November 2017 OBR report[21] which revised its projections for the UK deficit in 2021-22 to 1.3% of GDP from 0.7% in March 2017. Applying this change to Scotland would imply a 2021-22 deficit of between 6.7% (Scottish Trends) and 7.1% (IFS).

B4.32 A 6-7% fiscal deficit is not sustainable and action will be required to reduce it to more sustainable levels. The economic and political reality is that will require to be addressed whatever Scotland's constitutional position is. Independence allows future Scottish Governments to make decisions on how and in what timescale to reduce such a deficit.

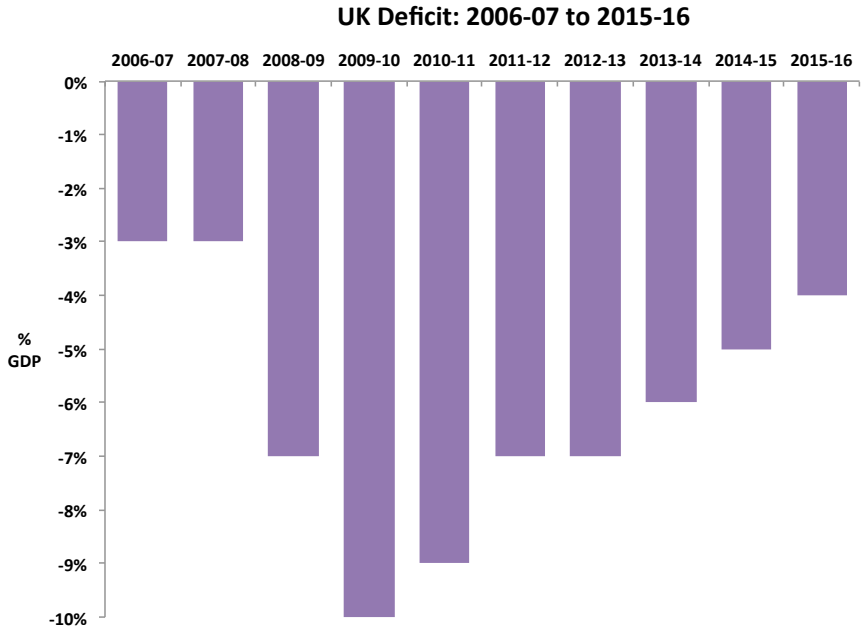
B4.33 However it can be noted that 6-7% is not out of line with recent UK deficit figures – it has been at 6% or more for 6 of the last 10 years.

[20] It should be noted that Scotland's current budget balance (excluding capital expenditure that would be expected to boost the economy's productivity in the longer term) is smaller than the net fiscal deficit – over the last 10 years Scotland's current budget deficit has typically been 2% lower than the net fiscal balance. The implication is that infrastructure spending and public investment have been running 2% lower in Scotland than in the rest of the UK.

[21] Office for Budget Responsibility (November 2017), Economic & Fiscal Outlook

B4.34 The Scottish deficit should therefore be judged to be both fundable and fixable, as is the UK deficit.

Figure 4-5 – UK Deficit

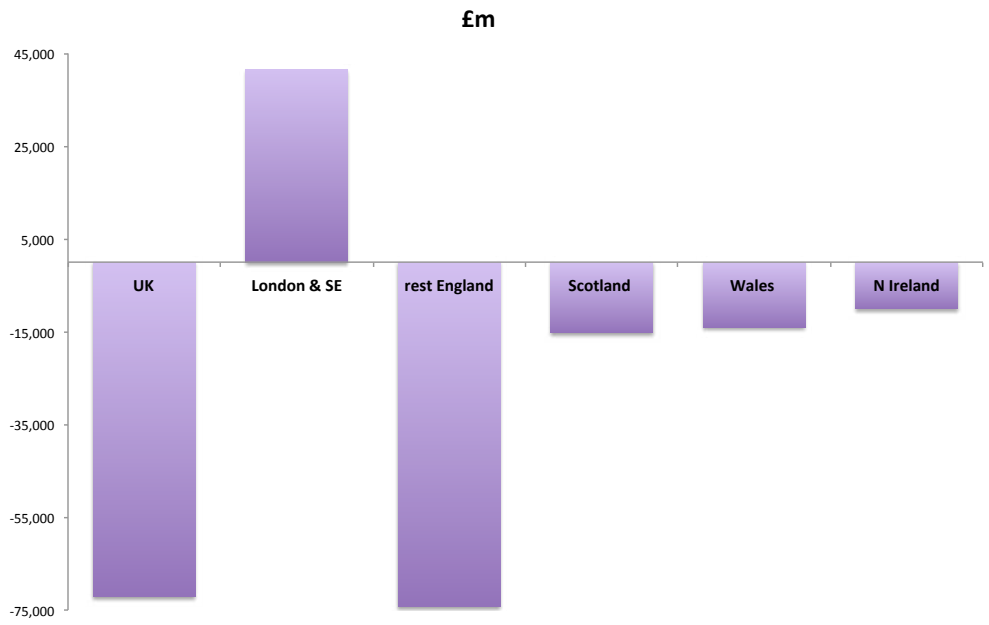


Source: GERS

B4.35 This report sets out a realistic and realisable plan for dealing with the deficit. It is not clear what the alternative plan would be if Scotland was to remain within the UK. However the evidence from the current planning period for the Scottish budget is for cuts of up to 6% by 2020-21, on top of a 5% real terms cut since 2010. The likely impact of Brexit should also be factored in to any assessment of Scotland's public finances within the UK.

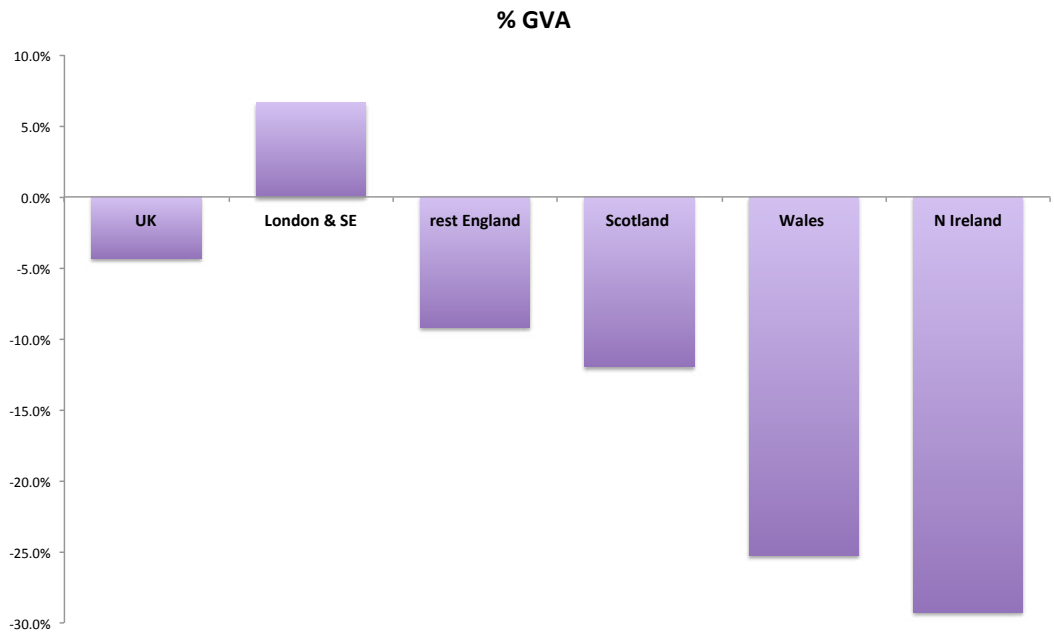
B4.36 Scotland's fiscal position makes very little difference to the overall fiscal balance of the UK, not surprisingly, given that Scotland accounts for a little over 8% of the UK's population. London and the South East of England had a net fiscal surplus in 2015-16 and most of the UK's fiscal deficit can be explained by the combined deficit of the rest of the English regions (Figure 4-6). As a proportion of the economy, the Scottish fiscal deficit is similar to that of the rest England (excluding London and the South East) and much less than that of Wales and Northern Ireland (Figure 4-7).

Figure 4-6 – UK Net Fiscal Balances, 2015-16 (£m)



Source: ONS (May 2017), Country and Regional Public Sector Finances Year Ending March 2016

Figure 4-7 – UK Net Fiscal Balances, 2015-16 (% Gross Value Added)



Source: ONS (May 2017), Country and Regional Public Sector Finances Year Ending March 2016

Annual Solidarity Payment

B4.37 As noted in Chapter B2 we recommend that, in the event of independence, a new Annual Solidarity Payment be introduced. Depending on the outcome of negotiated agreements on the fair and proportionate division of the UK's Liabilities and Assets, and on potential agreements on continued funding of some UK services for a transitional or extended

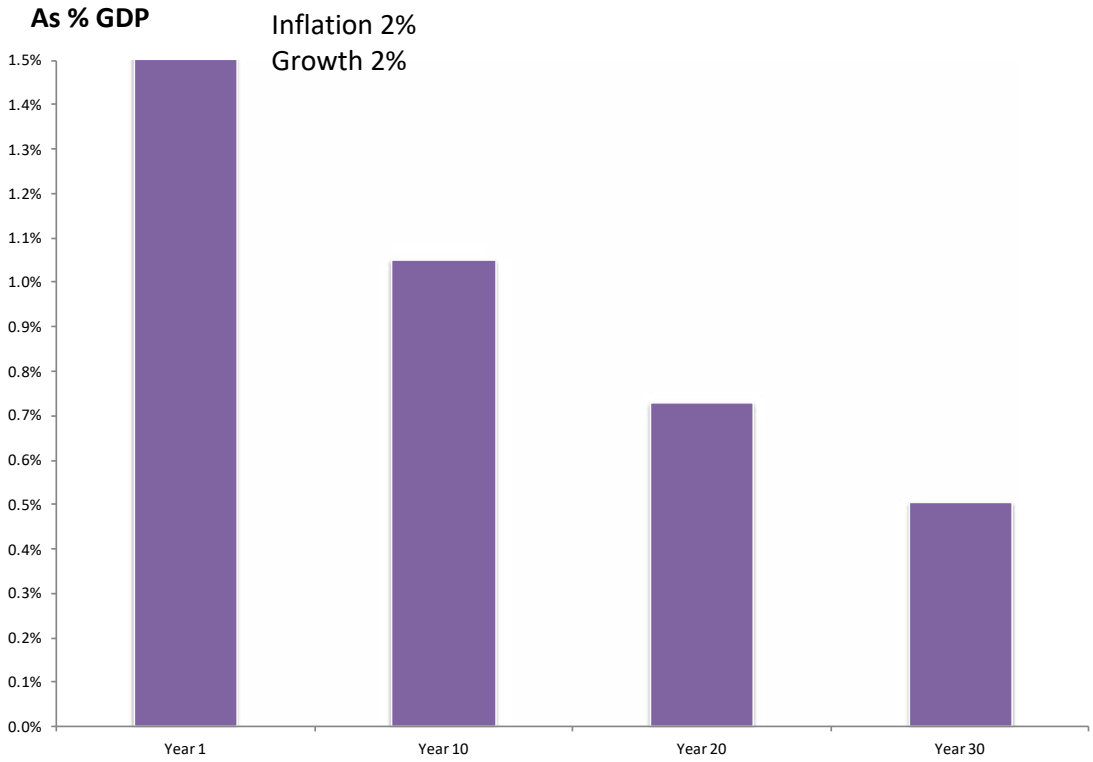
period, (for example Foreign Aid), we anticipate that this would be paid by Scotland to the UK Government.

B4.38 For the purposes of our analysis we estimate that the debt-servicing element of this is expected to be a maximum of £3.0 billion, as set out in Chapter B3. This would stay fixed in cash terms, and therefore would diminish in real terms over time and as a proportion of GDP as the economy grows. The addition of Foreign Aid (at 0.7% of GDP) would add £1.3 billion and a further £1.0 billion is assumed for other shared service agreements. Taken together we therefore estimate an Annual Solidarity Payment of £5.3 billion.

B4.39 This scale of payment recognises the continuing importance of links with the rest of the UK post-independence.

B4.40 However, over time the scale of the payment would diminish in real terms since the debt servicing costs would remain fixed in cash terms, depending on the structure of the negotiated agreement. Moreover, with economic growth, the payment should become less significant as a proportion of GDP within two or three decades depending on prevailing growth performance, as demonstrated here for illustrative purposes (Figure 4-8 shows that 2% inflation and 2% growth reduces payments association with UK historic debt serving charges by half within 20 years, expressed as a proportion of GDP).

Figure 4-8 – Annual Solidarity Payment (UK Historic Debt Servicing) Over Time (% GDP)



Source: Sustainable Growth Commission Analysis

B4.41 We fully recognise that the agreed outcome for this element of our proposals could be more or less depending on the outcome of negotiations. It is clearly in both Governments'

interests to negotiate in a positive and orderly way. The Scottish Government does not have zero leverage in those negotiations, in fact quite the reverse. But a broader agreement that is positive, orderly and respectful is important to securing the on-going social, economic and cultural relationship that has been built up over many centuries and that should endure any change of governing arrangements.

B4.42 If negotiations resulted in an agreement to make an Annual Solidarity Payment that was higher than this amount it may not be material to the longer-term deficit performance depending on which components make up the difference. It may affect the timing of the achievement of target policy positions at the margin and so we are confident in the efficacy of both the concept and the central assumption we use for this report's purposes.

Potential Savings for the New Scottish Budget

B4.43 The position of public finances in an independent Scotland would be a matter for the government of an independent Scotland, and the voters who chose that government. As discussed elsewhere in this report, there are examples of successful small advanced economies with relatively high levels of government spending and taxation and examples of lower levels of government spending and taxation. In all cases, the key issue is that the public finances remain in fiscal balance (other than borrowing for investment) over the economic cycle with debt and deficit policies controlled and credible.

B4.44 However, any debate on the desirable path for an independent Scotland requires an understanding of the starting point that would be inherited from the UK and some agreement also about an orderly transition as credibility is established and stability maintained.

B4.45 So, to establish a baseline position, it is helpful to consider where obvious and immediate savings may be achievable from public spending as well as an on-going approach to ensure efficiency across the public sector.

B4.46 There will be immediate opportunities where the Scottish Government would wish to make different choices quickly in areas currently showing in the GERS calculations, or where Scotland is contributing to UK spending choices, such as defence.

B4.47 Similarly, there are aspects of UK Government spending that are in Scotland and it has also been assumed that these aspects should be at least protected. Specifically, secured spending would include:

- social protection (pensions, unemployment benefit, welfare): £18.1 billion
- economic affairs (enterprise & economic development, science & technology, employment policies, agriculture, forestry & fisheries): £1.0 billion

B4.48 These areas account for £19.1 billion of the total £29.1 billion UK Government spending in Scotland or allocated to Scotland (2016-17 figures).

B4.49 There are areas where it seems likely that the Scottish Government may wish to entirely replicate UK spending (for example, the science budget given its importance as a driver of economic competitiveness in Scotland), areas where lower levels of spending may be required in a small country relative to a big country (for example, defence and foreign affairs) and other areas where there is an allocation of spending to Scotland but where there would be no need for spending by an independent Scottish Government (for example, areas considered to be for the whole of the UK but where the spending does not take place in Scotland, including UK Government administration).

B4.50 These total £7.7 billion in 2016-17 (projected to increase to £8.9 billion by 2021-22). This includes over £3 billion for defence and a further £4.7 billion which includes:

Table 4-2 – UK Government Spending Allocated to Scotland (Excluding Welfare & Debt Payments)

	£ million (2016-17)
General Public Services (Cost of Running UK Government)	484
International Affairs	810
Economic Affairs, including:	
- Enterprise and Economic Development	328
- Science and Technology	441
- Employment Policies	227
- Agriculture, Forestry and Fisheries	16
Transport	792
Public Order and Safety	232
Environment Protection	273
Health	149
Recreation Culture and Religion	397
Education and Training	6
EU Transactions	-66
Accounting Adjustments	606
Total (2016-17)	4,693

Source: GERS 2016-17

B4.51 It is notable that taxation raised in Scotland would be sufficient to pay for all services currently devolved and to meet all pensions and social benefits currently paid in Scotland by the UK Government.

Transferring UK Spending to Scotland

B4.52 In the early years of independence, it is likely that Scotland would wish to share some services with the UK, while domestic capacity is developed, learning from best practice

around the world. The proposed Annual Solidarity Payment would recognise that Scotland should contribute to the cost of such services in the meantime should the UK Government agree that this was orderly and appropriate. The estimated initial Annual Solidarity Payment is £5.3 billion.

B4.53 For defence spending, there would be choices about spending directly on defence or having some shared services with the UK, or a mix of both depending on the negotiations and the perspective of the UK Government. This is an area where a degree of continuity would make sense and there is the opportunity for Scotland to make a contribution to the United Kingdom defence budget via the Annual Solidarity Payment. A significant proportion of defence spending that is allocated to Scotland is spent outside Scotland, so there would be a limit to how much defence spending would be practical in Year One, whatever policy decisions were made. For the purposes of estimating the deficit prudently, it has been assumed that initial years' defence spending policy would be 1.6% of GDP (£3.1 billion in 2021-22 values), which is significantly ahead of the small European country average at 1.1%[22] and would place Scotland as the 8th highest in NATO out of 28 countries[23]. This spending is likely to be heavily focussed on procurement in the initial period which would have potentially very significant positive effect on domestic growth and jobs with a concomitant positive impact on the budget that is currently not felt in Scotland to the same extent.

B4.54 The UK Government spending allocated to Scotland also includes areas that are critical to economic competitiveness and future growth, such as the science and innovation budget and other spending on economic affairs. The science budget includes university research funding, where the Scottish universities have been successful is securing a greater than per capita share of UK funding for many years. An independent Scotland should *at least* match this spending, just over £1 billion (0.6% of GDP). This analysis also includes a further £0.5 billion to account for other UK spending programmes allocated to Scotland that a new independent Scottish Government may wish to replicate, chiefly in areas that would be expected to boost economic growth.

B4.55 Finally, there are the projections for 2021-22 including oil and gas revenues, which, as a windfall associated with natural resources, should be excluded from baseline fiscal planning. Excluding oil revenues increases the starting point 2021-22 deficit by £0.7 billion (0.4% of GDP).

[22] Defence spending of European countries with a population of less than 10 million is 1.07% of GDP on average, composed of Austria (0.68%), Croatia (1.40%), Cyprus (1.83%), Czech (0.98%), Estonia (2.03%), Finland (1.31%), Ireland (0.45%), Latvia (1.03%), Luxembourg (0.50%), Malta (0.61%), Slovakia (1.03%), Slovenia (0.96%), Sweden (1.08%) Source: European Defence Agency, National Defence Data 2015

[23] Source: NATO (March 2017), Defence Expenditure of NATO Countries (2009-2016)

Strategic Spending Reviews

B4.56 As part of the governance for the initial transitional phase the Commission recommends two further expert reviews are undertaken, ideally with a view to acquiring cross partisan support for the recommendations they reach:

A Comprehensive Review of Inherited UK Spending Programmes

B4.57 This should analyse the inherited strategy and choices for spending across the UK programmes identified in Table 4-2 above and report within 2 years. This would not include defence which would be covered separately but the range of spending across the costs of running UK Government, international affairs and the allocation to Scotland of UK spending in areas currently devolved such as public order and safety, environment protection, health and recreation and culture. This could ideally commence and conclude in the period between the referendum vote and the initial independence date but may take longer. It purpose would be to make recommendations for where savings could be made where costs need not be replicated and for where greater tailoring to Scotland's position could produce better outcomes from the spending being made.

B4.58 This analysis shows an improvement in the public finances of around £1 billion from allocated costs of £3.2 billion (the £4.7 billion shown in Table 6-2, less the £1.5 billion for science and innovation and other spending contributing to economic growth which should be at least matched), the equivalent of 0.8% of GDP. This is associated with two effects:

- Savings of £0.4 billion in areas that Scotland contributes to UK costs that will no longer be required (including, more than £50 million allocated to Scotland associated with running costs of the House of Commons and House of Lords, more than £20 million for the Scotland Office and more than £100 million for Whitehall Department running costs that will not need to be duplicated in Scotland); and
- Revenue benefits of £0.6 billion associated with spending that is allocated to Scotland but takes place elsewhere. When these activities are transferred to Scotland After excluding spending that mostly takes place overseas (foreign aid and embassies), there would be a total of £2.4 billion spending that would transfer to Scotland and so generate taxation revenues. Almost 70% of this[24] would be on staff wages and purchases of goods and services and of this, almost 37% would be expected to be taxation revenues[25], so giving a total of £0.6 billion.

B4.59 In addition, further savings can be achieved over time by creating best in class institutions, reducing the costs of governance (including, for example, the costs of tax collection, which are higher in the UK than in most small advanced economies). The future projections at the

[24] Analysis of the Whole of Government Accounts 2015-16 shows that, after excluding social security payments and debt interest, 30% of government spending is on staff costs and 39% on purchases of services (with the rest on pensions and other costs).

[25] GERS figures for the onshore economy show that taxation revenues accounted for 36.6% of GDP in Scotland in 2016-17.

end of Section B of this report show a further saving of around 0.3% of GDP. This is a modest saving and a larger saving than this is likely to be possible since some of the allocated spending by the UK Government in areas already devolved can be transferred to Scotland at small marginal cost.

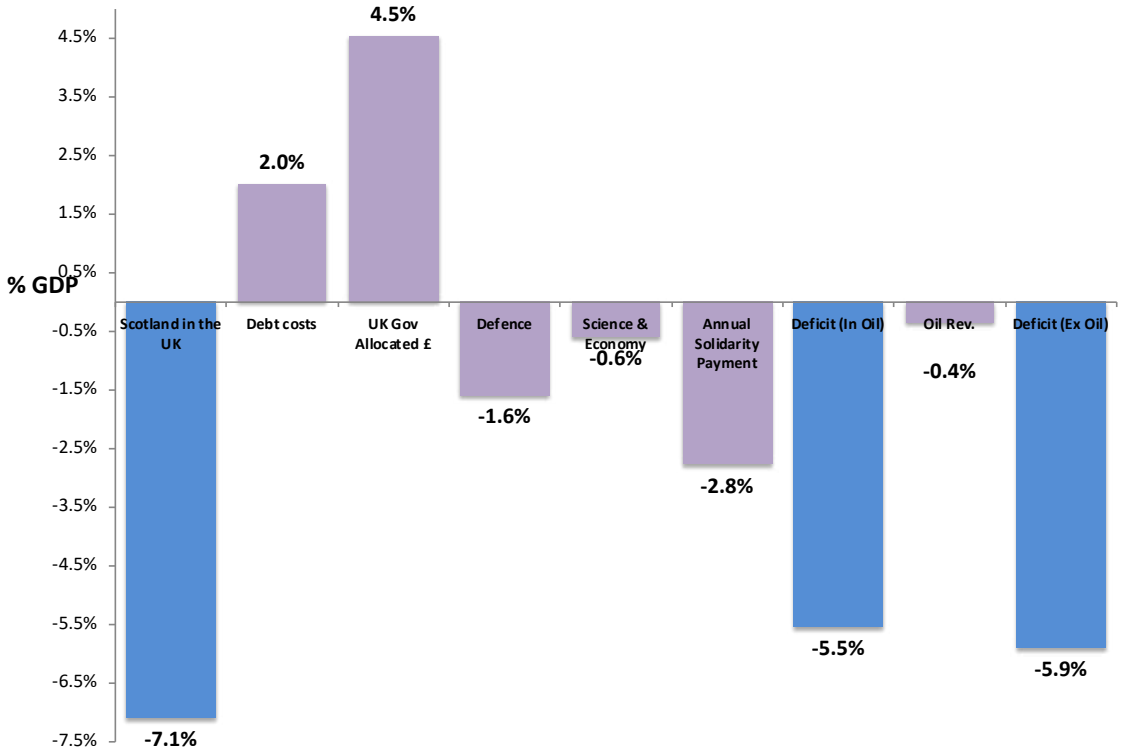
A Standing Council on Scottish Public Sector Financial Performance

B4.60 This needs to be a well framed call for an institutionalisation of the pursuit of high performance and best practice and benchmarking across the public sector incentivising, celebrating and rewarding where it delivers better outcomes and efficiencies. Legacy Deficit

B4.61 Overall, the legacy deficit that an independent Scotland would expect to inherit from the UK, based on projections for 2021-22, would be 5.5% of GDP (Figure 4-9)

B4.62 A further adjustment to exclude oil (which would be included in calculations for international comparisons but should be excluded for planning purpose), would give a deficit of 5.9% of GDP.

Figure 4-9 – Calculating Scotland's Legacy Deficit Starting Point



Source: Sustainable Growth Commission Analysis

B4.63 To put the illustrative inherited deficit position in some context, the UK's net fiscal balance was as high as 13.2% of GDP in 2010-11 and has averaged 6.8% of GDP since the financial crisis in 2008.

B4.64 It should be noted that this is a calculation of the starting point an independent Scotland's fiscal position - the legacy that would be inherited from the UK. An independent Scottish Government would be able to put in place an alternative fiscal framework (as recommended by the Commission) and to implement policies that would impact positively on Scotland's fiscal position over time.

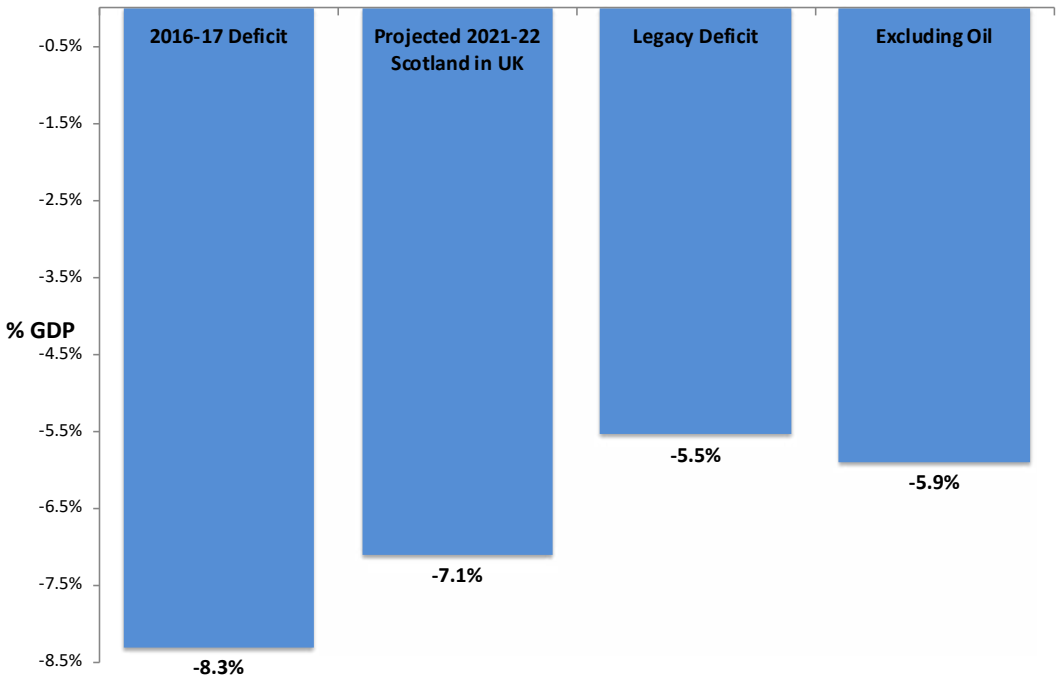
B4.65 It may be that the actual position is better than this, or it may be less favourable. This will depend on the performance of the UK budget and the economy in the coming period and on the outcome of negotiated agreements.

B4.66 In summary, while the GERS figures for 2016-17 showed a deficit position for Scotland in the UK of 8.3% of GDP, this is projected to decline to 7.1% of GDP within the current five-year fiscal planning period, by 2021-22 (including the latest OBR revisions, made in November 2017).

B4.67 Were Scotland to become independent, this would be reduced further by lower spending on defence (0.4% of GDP), lower debt servicing costs when a share of net assets is taken into account (0.4% of GDP) and savings from UK Government spending allocated to Scotland (0.8% of GDP), reducing the deficit to 5.5% of GDP.

B4.68 However, excluding oil revenues (0.4% of GDP), which would be allocated to Scotland's Fund for Future Generations, would take the starting point for the deficit to 5.9% of GDP (Figure 4-10).

Figure 4-10 – Summary of Deficit Position



Source: GERS, IFS & Sustainable Growth Commission Analysis

B5 SET UP COSTS & INVEST TO SAVE OPPORTUNITIES

- Total set-up costs to establish departments and agencies of around £450 million over 5 years, or £90 million per year for 5 years, based on the analysis of Professor Patrick Dunleavy of the London School of Economics.
- Most of these costs would be associated with establishing four new bodies: a defence force and associated defence ministry, a foreign affairs and trade department, a security and intelligence agency, and a central bank and financial regulator.
- Additional civil service personnel of around 4,100, an overall increase of public sector employees of 1%. The costs of additional personnel based in Scotland will have no additional costs (other than those included in transition costs) since these staff are paid for by Scottish taxpayers already, but based elsewhere in the UK.
- Transition costs recovered within 6 years, from additional taxation revenues from the transferred personnel and activity.
- Net economic impacts are positive and substantial, since the additional income associated with transferred employees exceeds costs, even in the transition period, with additional income to the Scottish economy of almost £226 million per year and additional tax revenues of over £75 million.

B5.1 The analysis set out in this chapter is based on research undertaken by the London School of Economics (LSE), led by Professor Patrick Dunleavy, an expert in public sector institution building and public sector productivity. The focus of the research was on the transition period costs of setting up a new Scottish state (for two years before and three years after independence).

B5.2 The approach taken involved a number of stages. First, the LSE research team put together a comprehensive list of all UK departments, executive agencies and other main QGAs (quasi-governmental agencies) from multiple webpages across the official gov.uk site. They identified and removed all organisations where powers are already fully devolved to the Scottish Government, and those relating solely to other parts of the UK outside Scotland. They also discounted a number of small organisations where they considered it unlikely that it would be necessary or viable for Scottish Government to create free-standing bodies rather than allocating the functions in question to other, larger agencies.

B5.3 In this reduced list they identified departments or agencies that already exist in some form within Scotland, i.e. with staffs, buildings, IT and transaction systems etc. already fully in place, but where the policy-making direction currently comes from Westminster. These agencies already-in-being would need to be somewhat reorganised at the top tier, so that policy making resides with Scottish ministers and the Scottish Parliament. Normally this would entail creating new policy-level staffs and structures (which is relatively inexpensive), and in a few large cases inaugurating a longer-run programme to progressively 'disentangle' systems or parts of integrated administrative functions currently run elsewhere

in the UK. But in most cases more deep-rooted reorganisations would not be needed, e.g. of field agencies and implementation systems. In the short term it has been assumed that the Scottish Government could contract with Whitehall departments to continue supplying essential services located outside Scotland for a transition period, at a cost that would be comparable with or only slightly more costly than the current setup.

B5.4 The final category consists of organisations that currently have no counterparts or existence within Scottish Government, or located in Scotland, and hence will entail setting up new departments (in a very few cases) or agencies. Data was collated from countries that are comparable to Scotland in terms of population size (especially Denmark, Norway, Finland and New Zealand, and sometimes Sweden) and adjusted for some relevant differences (such as population size, GDP and governing traditions etc.). Weighted averages provided a basis to estimate what the size of new agencies might need to be and what level of spending would be entailed. This was then compared with other estimates of the UK staffs or spending happening north of the border on comparable functions.

B5.5 It was also assumed that staff already working in Scotland only on delivering services to Scottish residents will remain in post and transfer across to the Scottish Government under ring-fencing arrangements. In practice a certain quota of staff will use this opportunity to retire, and a further proportion may wish to relocate to the remaining UK for family or career reasons. Administrative reorganisations around such changes can often result in significant staff savings. But these would depend on the decisions made by Scottish ministers at the time, who may wish to maintain staffing levels. It was assumed that either replacement staffs would be recruited, or organisation and staffing changes would compensate. However, some key cases where specialist expertise or larger numbers of staff might be involved were also considered.

B5.6 To compute net cost additions the focus was on the two years leading up to an independence date, and the first three years after it. Evidence from an authoritative study of Whitehall reorganisations shows that even the most complex ones were substantively accomplished within three years[26]. This approach also now includes a broader range of costs within the definition of transition-period costs than previous work undertake prior to the 2014 referendum.

B5.7 The LSE team consulted extensively with a range of experienced UK decision-makers (and some academics) in each of the areas where new Scottish departments or other major institutions would be needed. The LSE team consulted non-attributably to senior people in each of the main cases, and to identify the main dimensions which could bear on costs and timing issues. The LSE team is most grateful to all respondents.

[26] White and Dunleavy (2010)

New Departments

B5.8 Creating new institutions will entail costs for the Scottish Government in four areas: a Defence Department and Scottish armed forces, a Foreign Ministry and a diplomatic service, an integrated Security and Intelligence Agency and a central bank and financial regulator.

Defence and Armed Forces

B5.9 As a population pro-rata share of the UK's current armed forces, the Scottish armed forces would number around 12,600[27], and that this total is similar to that in New Zealand (which has a smaller population). However, it is smaller than the armed forces of Norway and Denmark, two NATO ally states. The civilian defence workforce in an independent Scotland would be under 700 staff, if we transpose UK levels on a population-proportional basis. On the UK pattern about half these staff would be in the Defence Department HQ. If Scottish armed forces were somewhat larger, these numbers might increase to around 1,000 civilians.

B5.10 If Scotland committed 1.6% of GDP to defence expenditures it would spend less compared with its population pro rata share of current UK defence spending. It is estimated that in the transition period (two years before and three years after independence) there would be extra costs of around £100 million (so £20 million per annum) in creating a new Defence Department, higher tier armed forces functions and decision-making processes, and in immediately disentangling Scottish defence capabilities from decisional dependence on UK institutions. Substantial contracting for services with the rest of the UK would also be needed, but at only a small cost increment from current provisions.

B5.11 However, although this sum is included within the overall £450 million transition-period costs, it should be noted that these cost increments are likely to be easily absorbed within Scotland's defence budget because of logistically inevitable spending reductions involved in the early years of creating a new, small-country defence provision.

Foreign Ministry and Diplomatic Service

B5.12 It is estimated that the additional transition period costs of creating a new (integrated) Foreign Ministry would initially be between £100 million (with a minimal embassy spread of 55 countries) and £150 million (covering 80 countries), in addition to minimal population-proportional funding of £135 million a year already covered in Scotland's share of UK tax receipts. Smaller additional amounts covering salaries for around 200 more staff than already implied (on a population-proportional basis) would also accrue as on-going extra costs.

[27] Scottish Government statistics (March 2017) on public sector employment show 10,100 armed forces employees in Scotland and so this would imply an additional 2,500

Security and Intelligence Agency

B5.13 A Scottish Security and Intelligence Agency (SSIA) providing internal and international security, cyber/electronic surveillance agency, defence intelligence and special forces would require 300 to 550 staff and have relatively modest functions, proportional to risks to Scotland. All of its running costs would seem to be more than covered in a population-proportional share of existing UK intelligence and homeland security spending. However, capital costs in creating new IT systems and acquiring secure (temporary) buildings of around £50 million would accrue in the transition period.

Central Bank and Financial Regulator

B5.14 The functions of a central bank and financial regulator are covered in Part C. For the purposes of this analysis we include maximum transition-period costs of £50 million (it could well be less) to cover the run-up costs of establishing a central bank and regulators and acquiring (temporary) secure buildings in the two years of the institutions' existence *pre*-independence, before they commence operations. However, the bank and regulator should be able to repay set-up costs (with interest accrued) within its first decade of operations. The staff cost analysis assumes a cohort of 1,500 staff in a central bank and financial regulator (similar staffing levels as in Ireland).

Absorbing and Managing Staff from UK Departments Already Operating in Scotland

B5.15 After independence the Scottish Government will take over major UK administrative systems that operate within Scotland for collecting taxes (HMRC), paying social security (DWP), issuing passports and immigration. 'Repatriating' these powers will entail creating new decision-making and control structures in Scotland. The Scottish Government, as a result of the extension of the powers of the Scottish Parliament, has recently established Revenue Scotland and the Scottish Social Security Agency, beginning the development of new systems and the recruitment of expertise which can be extended to deliver the full range of services that would be required under independence. It will also involve 'disentangling' some parts of these systems from UK-wide operational structures - although inter-governmental contracting should allow any cost additions here to be modest in the transition period.

B5.16 Other departments and agencies would include:

- Extension of Revenue Scotland (HQ staff of 100, accommodation and some new IT provision);
- Extension of Scottish Social Security Agency (HQ staff of 100, accommodation and some new IT provision, reorganisation cost of £25 million);
- Scottish Passport Office (no additional staff required and marginal transition costs);

- Scottish Border and Homeland Security (additional 150 staff and transition costs of £30 million);
- Single Economic Regulator (like UK regulators fees would be set to cover costs);
- Debt Management and Assets Office;
- First Minister, Cabinet Office and Department of Finance (Up to 240 additional staff and transition costs of £40 million); and
- Other Scottish Government departments (35 additional staff and transition costs of £35 million).

Summary of Transition Costs

B5.17 An independent Scotland would face total transition-period costs of around £450 million in the two years leading up to independence and the first three years immediately afterwards, in creating new administrative structures that duplicate UK institutions – or around £90 million extra costs per year.

B5.18 Most of these costs would be associated with establishing four new bodies:

- a defence force and associated defence ministry;
- a foreign affairs and trade department, along with overseas embassies and representation;
- a security and intelligence agency; and
- a central bank and financial regulator.

B5.19 In addition, there will be smaller costs in:

- adapting central decision-making components to add to the UK administrations already existing within Scotland for collecting taxes (HMRC and Revenue Scotland), paying social security (DWP and Scottish Social Security Agency), and creating functions for immigration, borders and homeland security (Home Office).
- disentangling some parts of these systems from UK-wide operational structures, although inter-governmental contracting should allow any cost additions here to be modest in the transition period.

Table 5-1 – Summary of Estimated Transition Costs & Additional Staff

	Transition Cost (£m)	Additional Staff
Armed Forces	-	2,500
Defence	100	1,000
Foreign Affairs	125	590
Security Services	50	425
Central Bank & Regulation	50	1,500
Revenue	15	100
Social Security & Pensions	25	100
Homeland Security	30	150
First Minister's Office & Finance	40	240
Other	4	35
Total	439	6,640
Ex Armed Forces		4,140

Source: LSE

B5.20 The transition would also imply an additional 2,500 members of the Armed Forces based in Scotland (since Scotland currently has a less than per capita share of these personnel) and more than 4,100 additional civil servants. These would be permanent positions but would not imply any additional costs since Scottish taxpayers are already paying for these services and departments, but they are located outwith Scotland.

B5.21 To put this in some context, there are currently 543,000 public sector employees in Scotland, of whom 5,500 are Scottish Government civil servants[28]. So this would represent an increase of 1% in public sector employment and to place this in some context, there were 577,000 public sector employees in Scotland in 2005[29].

Economic and Fiscal Benefits

B5.22 The transition of these governance arrangements would provide opportunities to create best in class institutions, and improve the quality of governance and the productivity of public services.

B5.23 In addition, they would also generate economic and fiscal benefits since the additional public sector staff based in Scotland would result in additional income and taxation income.

[28] Source: Scottish Government (March 2017), Public Sector Employment in Scotland

[29] Source: Scottish Government (September 2005), Public Sector Employment in Scotland

B5.24 Table 5-2 summarises the scale of such benefits that would be expected, based on conservative assumptions on salary levels. The armed forces salary levels are based on an average of £20,000, just above the salary of a Private in the army[30] and the civil servant salary costs are based on the median salary in the UK civil service of £30,000[31], with the exception of the First Minister and Finance departments, and the Central Bank and financial regulator, where an average of £60,000 has been assumed, reflecting the senior nature of these posts.

B5.25 The additional tax revenue estimates have been based on the average tax take from UK households of one third of gross income[32].

B5.26 On this basis, the additional staff would result in additional income to the Scottish economy of almost £226 million per year and additional tax revenues of over £75 million.

Table 5-2 – Economic and Financial Benefits

	Additional Staff	Salary Costs (£m)	Additional Tax Revenue (£m)
Armed Forces	2,500	50.0	16.7
Defence	1,000	30.0	10.0
Foreign Affairs	590	17.7	5.9
Security Services	425	12.8	4.3
Central Bank & Regulation	1,500	90.0	30.0
Revenue	100	3.0	1.0
Social Security & Pensions	100	3.0	1.0
Homeland Security	150	4.5	1.5
First Minister's Office & Finance	240	14.4	4.8
Other	35	1.0	0.4
Total	6,640	226.4	75.5

Source: Sustainable Growth Commission Analysis

B5.27 On this basis, the net effects of the transition in governance on the Scottish economy would be a positive contribution to the budget, even in the transition period when additional costs are incurred, since the additional income of around £226 million would be greater than the additional costs of £90 million.

B5.28 And the additional taxation revenues of around £75 million per annum would mean that the total projected transitional costs of £450 million would be recouped within 6 years.

[30] Source: British Army Rates of Pay (2016)
[31] Source: ONS Civil Service Median Pay (2015)
[32] Source: ONS (April 2017), Effects of Taxes and Benefits on UK Household Income

B6 FUND FOR FUTURE GENERATIONS

- All future North Sea Revenues should be set aside in a new Fund for Future Generations, along with any other windfalls such as asset sales or one off revenue raisers.
- Such a fund could be established within or invested via the Scottish National Investment Bank, currently being established by the Scottish Government.
- The UK Government has received around £328 billion in real terms revenue from the North Sea production over the past 40 years.
- The role of the Fund would be different in scale and ambition from Sovereign Funds that anticipated the oil boom such as in Norway (the Norwegian fund is worth around £750 billion).
- The focus of this Fund would instead be on risk bearing by the public sector, and on exploiting inter-generational opportunity in the areas of Inclusive Growth, Transformational Innovation and Infrastructure and the Green Economy.
- Further work is required on the detail of its remit and governance.

B6.1 The analysis of the fiscal position of an independent Scotland discounts oil revenues, assuming they will be zero for planning purposes. Oil revenues should be treated as a windfall fiscal bonus. The failure of successive UK Governments to take such an approach is another example of poor fiscal and economic management. The UK Government has received around £328 billion in real terms revenue from the North Sea production over the past 40 years.

B6.2 As has been shown repeatedly, oil revenues are difficult to forecast. HM Treasury and the OBR failed to predict both the oil price rise and high oil revenues at the start of this decade and the more recent reduction in oil prices and revenues.

B6.3 It should however be noted that the decline in oil revenues in recent years has not been entirely because of the fall in oil prices but also due to UK Government policy decisions. Oil prices have fallen by around 40-45% since 2014 and output has increased by 15-20%. Therefore, market conditions only account for a proportion of the reduction in oil revenues. The driver has been policy decisions on rates to reduce tax revenues from the oil and gas sector and allowing producers to set decommissioning costs against past investment to reduce tax liabilities.

B6.4 Even based on this policy environment, the OBR forecast in December 2016 oil revenues for 2017-22 of £7.3 billion, which it then reduced to £4.6 billion in March 2017 and £3.3 billion in November 2017 and then increased again to £5.5 billion in March 2018. At least 80% of these revenues would be associated with Scotland's geographic share of oil and gas revenues.

B6.5 The Commission recommends that revenues of this kind should be placed into a Fund for Future Generations, along with any other windfall income, such as from asset sales. Such a fund could be established within or invested via the Scottish National Investment Bank, currently being established by the Scottish Government.

B6.6 This would be different in both scale and purpose from other oil funds, such as the Norwegian Fund. The size of that fund reflects the foresight of the Norwegian Government in setting it up while oil revenues were particularly high rather than spending the windfall as happened in the UK. The Norwegian Fund is largely used to invest overseas, which helps manage the exchange rate and is worth around £750 billion.

B6.7 The situation in Scotland is different and, therefore, the Fund for Future Generations should have a different role. It would be an investment fund that would allow for long-term policy making, investing to achieve a return on capital but in projects that also generate growth in Scotland and associated fiscal benefits. The risk bearing long-term projects will focus on the areas of Scottish need, opportunity and comparative advantage, including on:

- inclusive growth initiatives;
- transformational innovation and infrastructure (additional to investments that would be usually be associated with existing programmes and infrastructure provision); and
- the green economy (including the next generation of renewable energy technologies).

B6.8 The governance and strategy for the fund should be consulted on in detail and an initial assessment produced by the Scottish Futures Trust in conjunction with expertise from the Scottish Investment industry and the new Scottish National Investment Bank. The returns in some policy areas may be less simple to calculate and recoup than in others. An early challenge for the set up for the fund will be deciding on how it will obtain a return where the initiatives it has invested in produce financial value for the exchequer that is not directly returned to the fund. The most obvious of these would be programmes to encourage economic participation.

B7 FISCAL FRAMEWORK & GOVERNANCE: INTERNATIONAL EVIDENCE

- There is a wide variety of evidence of how other small advanced economies have reduced deficits to a healthy and sustainable position. Indeed, many of the fiscal challenges experienced by those economies represent far greater problems than would be inherited by Scotland on our analysis. Scotland's fiscal starting point is challenging, but it is a proposition that is fundable; and making it quickly sustainable is both achievable and essential whether Scotland is independent or not. The real question is how that is best achieved?
- OECD evidence demonstrates average consolidations from fiscal deficits of 7% to 1%, in comparison to Scotland's anticipated starting point of 5.9% to a target of less than 3%.
- In general, small advanced economies pursue policies of more prudently managed debt and deficits than larger countries.
- Small advanced economies tend to respond (by necessity) more quickly and effectively to economic shocks than larger economies.
- Scotland should benchmark itself against the small advanced economies it wishes to emulate in its fiscal policies and governance, rather than against the UK which is not a prudent or successful example.
- Scotland should also learn the lessons of both international examples and recent UK policy history by tending carefully to the impact of any deficit reduction on growth performance. Scotland should explicitly reject the austerity model pursued by the UK in recent years. Scotland needs to focus on both the real economy, and putting finances on a sustainable footing, as dual fiscal goals.
- IMF evidence suggests that a gradual pace of fiscal adjustment is only credible if embedded in a medium term strategy buttressed by strong budget institutions.

B7.1 Decisions about the scale and pace of moving to a sustainable deficit position in Scotland will be shaped by both economic and political considerations. But irrespective of the fiscal policy choices made, it is vital that a robust institutional framework is established to support the journey to sustainable public finances and on-going financial management. Otherwise there is a high risk that the desired fiscal outcomes will not be achieved, or will do so in a way that causes unwarranted economic, financial or social stress.

B7.2 The design of these fiscal institutions is a central part of the process.. The development of a robust process for financial decision-making is a strategic priority, central to achieving the desired fiscal outcomes for Scotland.

B7.3 This section begins by looking at definitions of fiscal sustainability to calibrate the steps a small country like Scotland will need to deliver to reach a sustainable position. It next looks at the international experience of deficit reduction: how have they been achieved, what is

the economic and fiscal impact, and what are the common characteristics of successful fiscal sustainability transitions.

B7.4 There is specific focus on the extent to which fiscal institutions have been supportive of the success of these efforts. The analysis is informed by a series of small country case studies and examples. It identifies a series of insights and implications for Scotland.

B7.5 At the outset, given the analysis in the chapters above, what is clear from the international examples is that Scotland's position is relatively better in the round than many of the countries that have faced fiscal challenges, especially on debt. Scotland's fiscal starting point is relatively challenging, but improving Scotland's fiscal position is a proposition that is fundable, and entirely achievable without continued austerity. It should also be noted that achieving the economic growth objectives set out in Part A would accelerate the process.

B7.6 Following the best governance and policy approach of the most successful benchmark countries would support Scotland's transition to a model of sustainable economic growth.

B7.7 The imperative to do this is real, and we judge the risks of maintaining the current approach within the UK to be very significant and potentially very damaging. It is perhaps because the analysis we have provided above has not yet been considered by so many critics of the Scottish position that the debate thus far has been badly framed, locked in and narrowly considered.

The Performance of Small Advanced Economies

B7.8 What is a sustainable level of debt to serve as a threshold? It makes sense to think about fiscal sustainability in terms of stabilising public debt level at some threshold (given the prevailing long term outlook for GDP growth, interest rates, demographics, and so on).

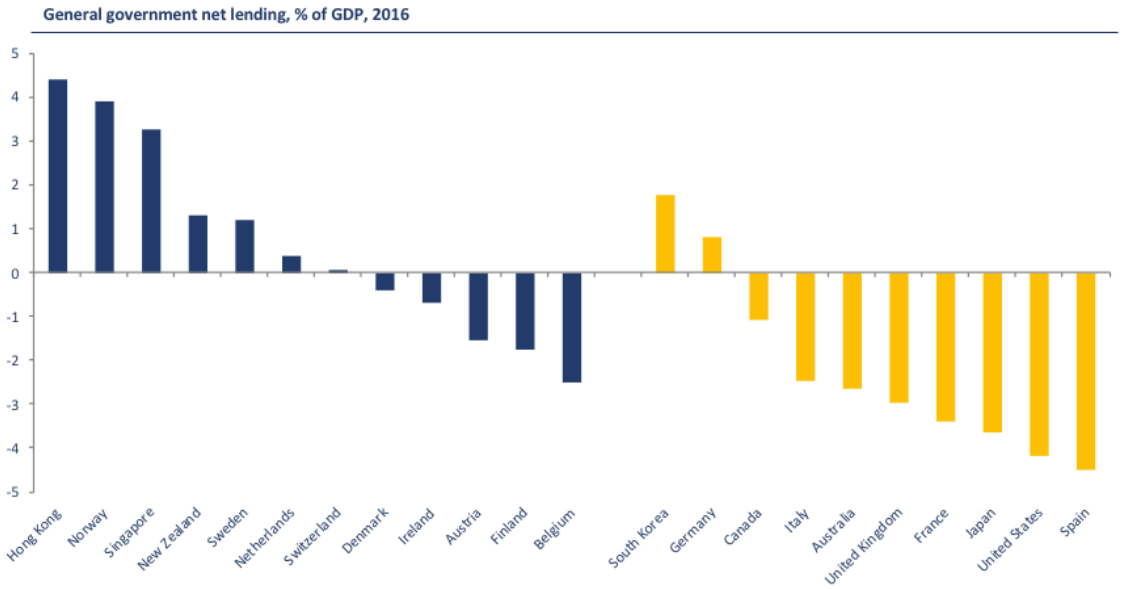
B7.9 For practical purposes, various guidelines are used to define fiscal sustainability – based on the international experience. The IMF, for example, has a working definition of fiscal sustainability: the cyclically adjusted primary balance that would stabilise debt/GDP ratios at less than 60%, given assumptions with respect to the structural fiscal pressures of an aging population, as well as assumption on growth rates, interest rates, and so on. Similarly, the OECD notes that economic costs begin to emerge when gross public debt rises above 70-90% of GDP in developed countries; and for Eurozone members the prudent debt level is estimated to be 50-70% (because of the absence of independent monetary policy flexibility to respond to shocks).

B7.10 High debt levels impose a range of costs, including higher interest rates, the crowding out of private sector activity, elevated levels of uncertainty, as well as reducing the ability of the government to respond appropriately to a shock through fiscal stimulus measures (which will increase the severity and length of a recession).

B7.11 In sum, public debt levels of below 60% of GDP are a broadly accepted definition of sustainability. For example, this is reflected in the EU's Growth & Stability Pact fiscal thresholds: 60% debt and 3% deficit. Its successor, the European Fiscal Compact, specifies limits of 60% debt and 0.5% deficit as measured across the cycle.

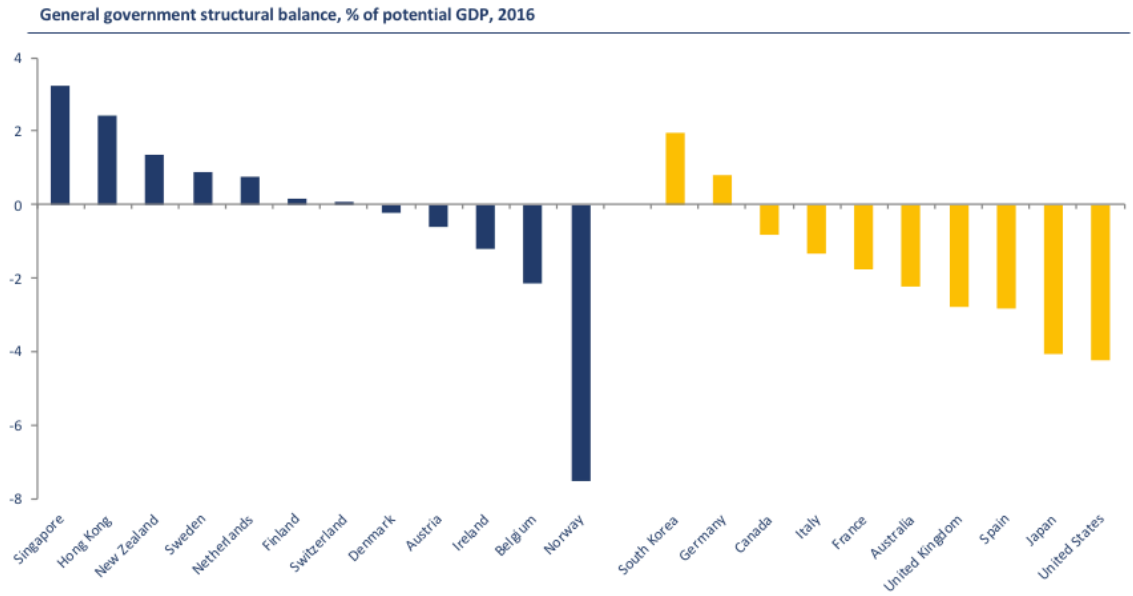
B7.12 Indeed, developed country governments have shown an aversion to running debt at higher levels. This is particularly so for small advanced economies, suggesting that the sustainable (or desirable) level of public debt, and the size of the fiscal deficit, is lower for small advanced economies than for larger economies. The following figures show that small advanced economies have consistently run small deficits (or surpluses) over the past decades and tend to have relatively low levels of public debt.

Figure 7-1 – Small advanced economies tend to run relatively small fiscal deficits, or surpluses. Note that the UK has a relatively large fiscal deficit



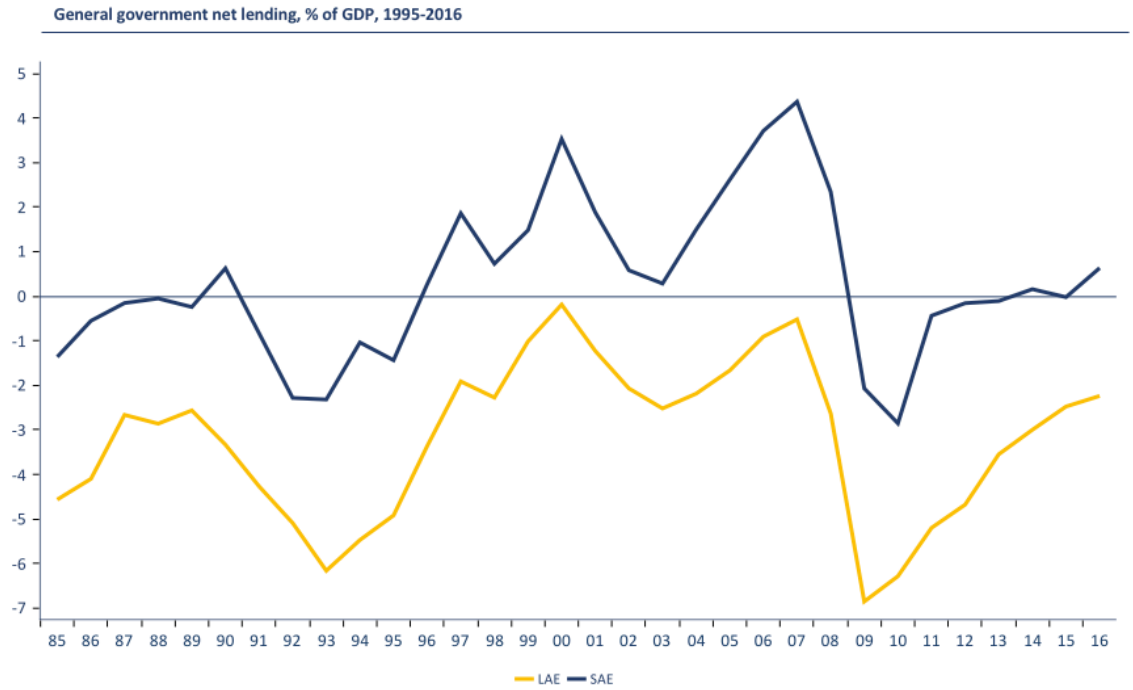
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-2 – Structural fiscal balances also tend to be stronger in small advanced economies



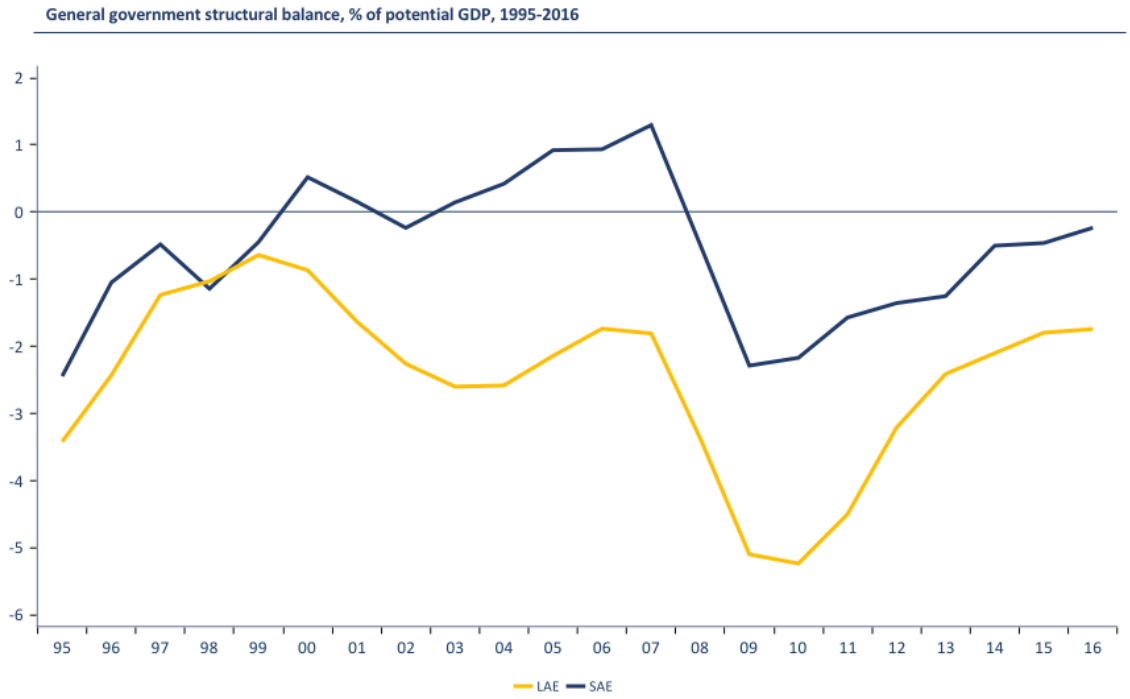
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-3 – Small economies have consistently run stronger fiscal balances over the past 20 years, including through the financial crisis period



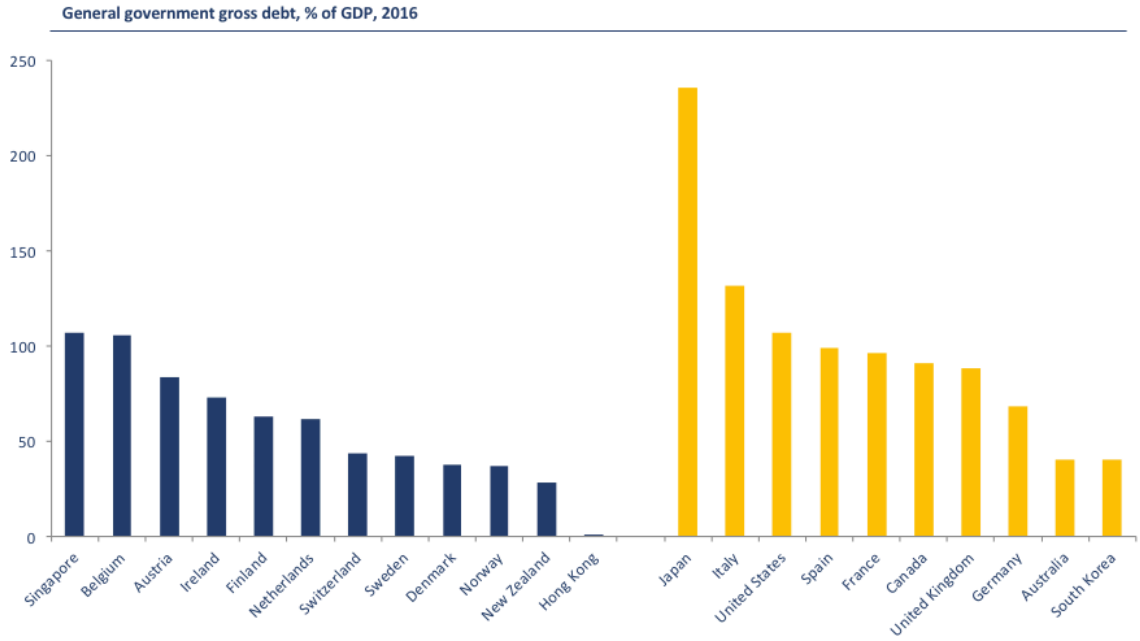
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-4 – The same strong fiscal performance by small advanced economies is also evident on the structural fiscal balance



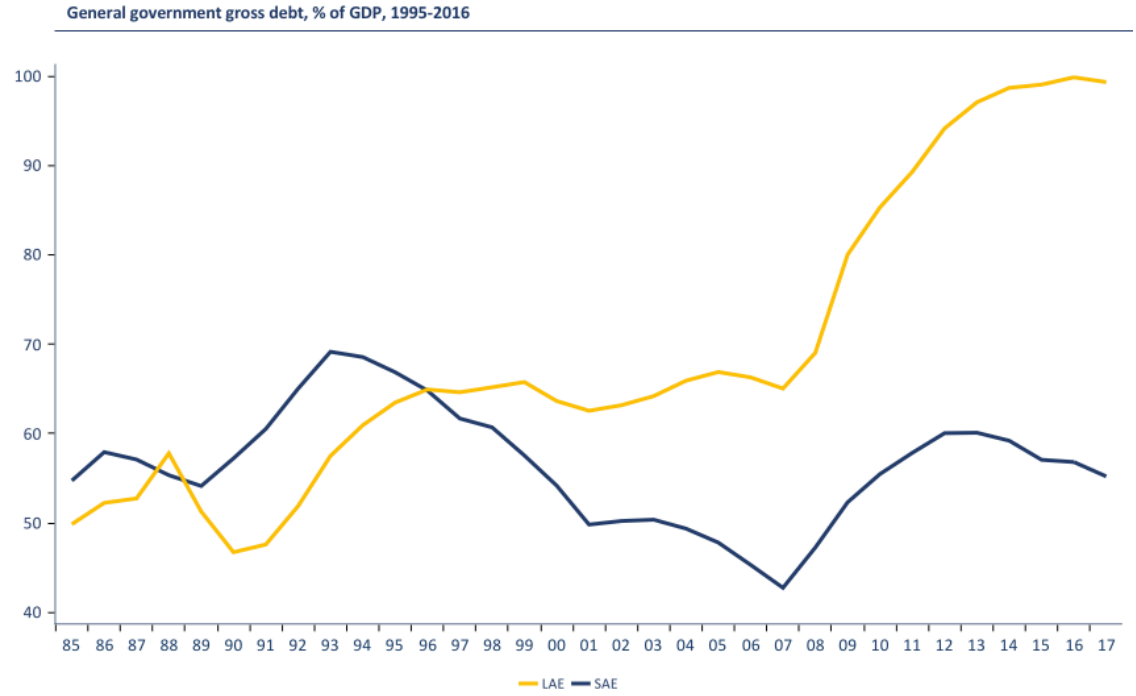
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-5 – Small advanced economies tend to have lower levels of public debt than larger economies



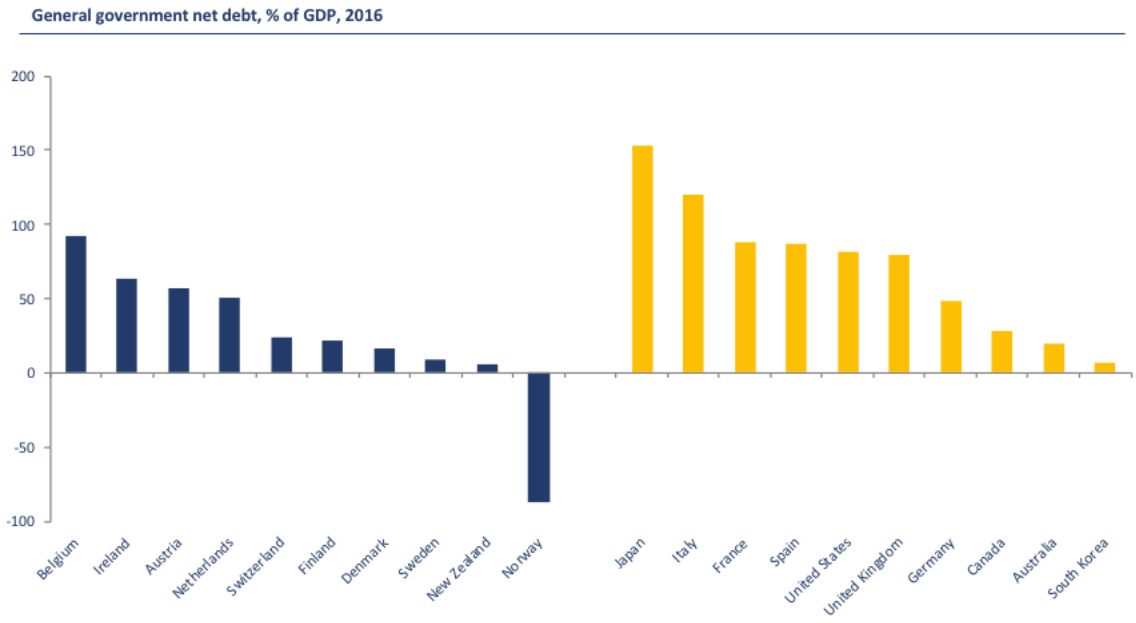
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-6 – Small advanced economies have kept their levels of gross debt at more stable levels



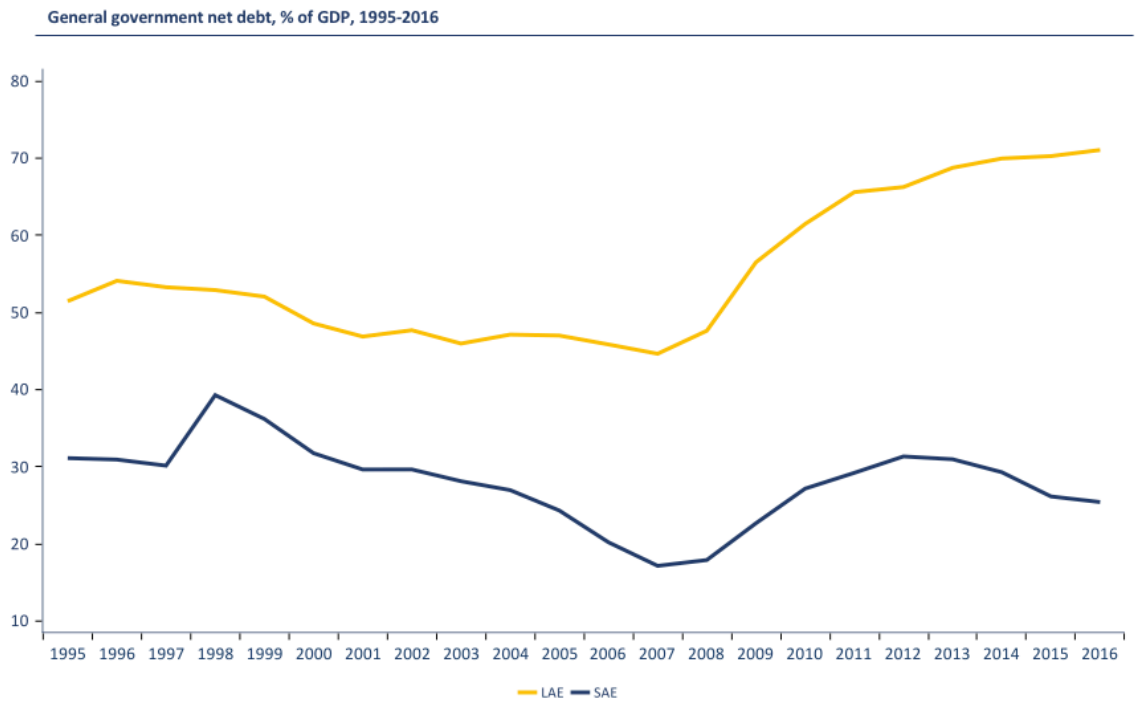
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-7 – The same strong small economy picture is also seen in terms of net public debt positions



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-8 – The small economy net debt profile over the past two decades has been more stable; it has trended up in large advanced economies

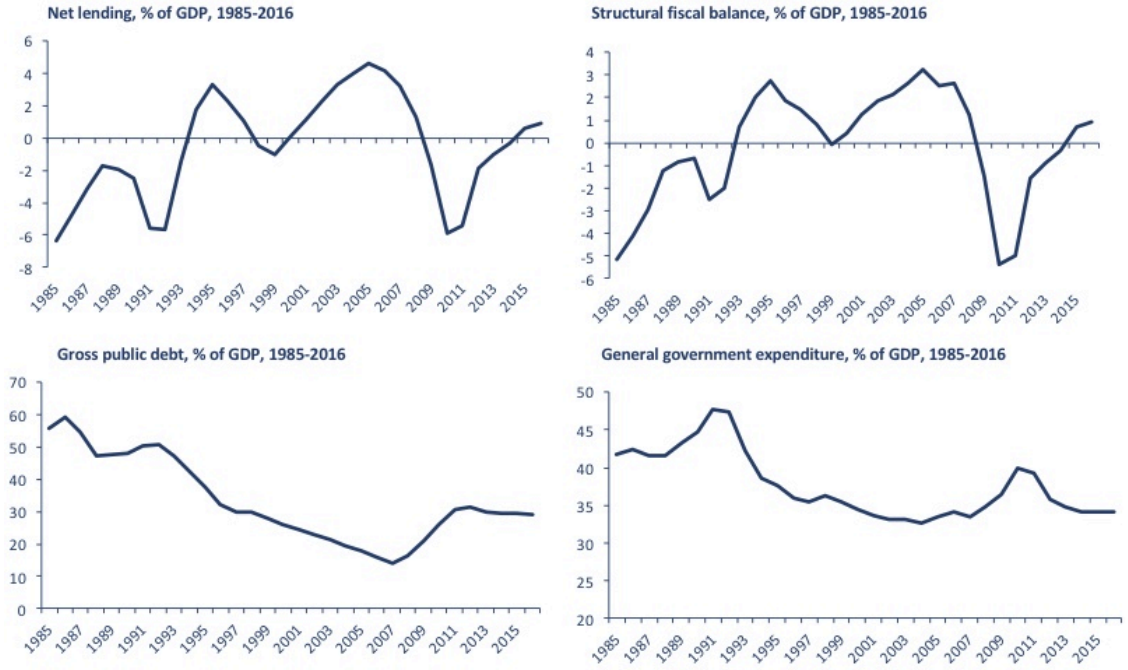


Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

B7.13 Small economies also tend to respond rapidly to economic shocks that cause a weakening of the fiscal position (New Zealand, Ireland and Finland are some recent examples, see Figure 7-9, Figure 7-10, Figure 7-11, and Figure 7-13).

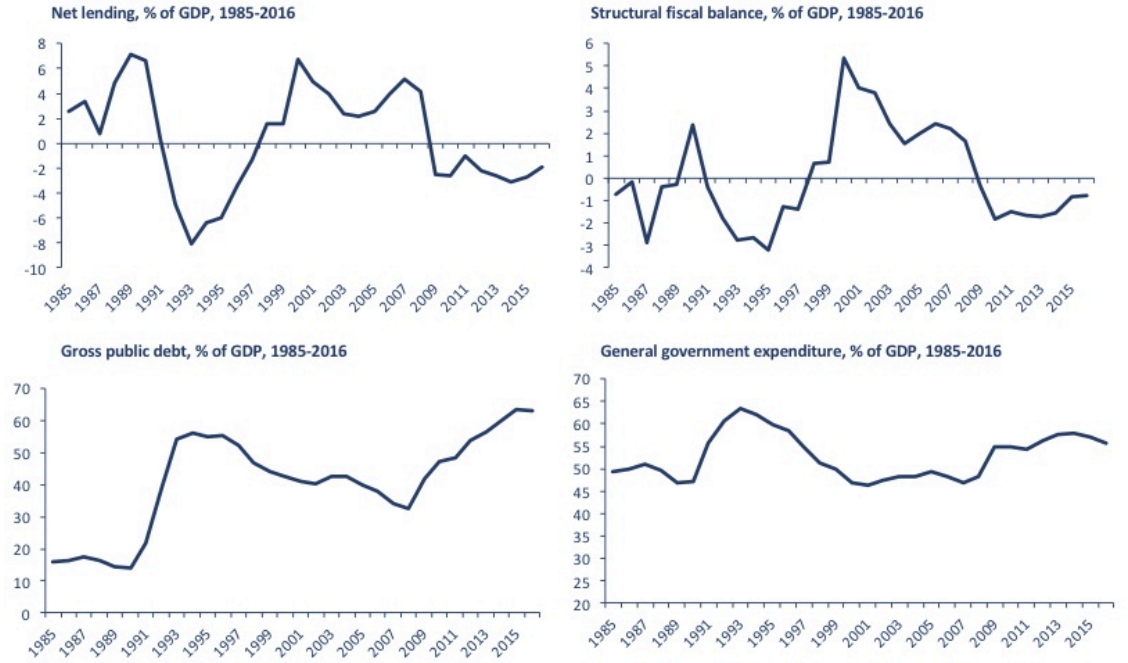
B7.14 And in general, the structural fiscal balances in these countries have improved more markedly after the fiscal shock of the global financial crisis; fiscal consolidation has been a key feature of the post-crisis policy approach in small advanced economies. These examples also show how small economies have responded to fiscal deficits greater than that faced by Scotland.

Figure 7-9 – New Zealand has consistently exerted fiscal discipline since the early 1990s, and responded quickly to the shock from the financial crisis



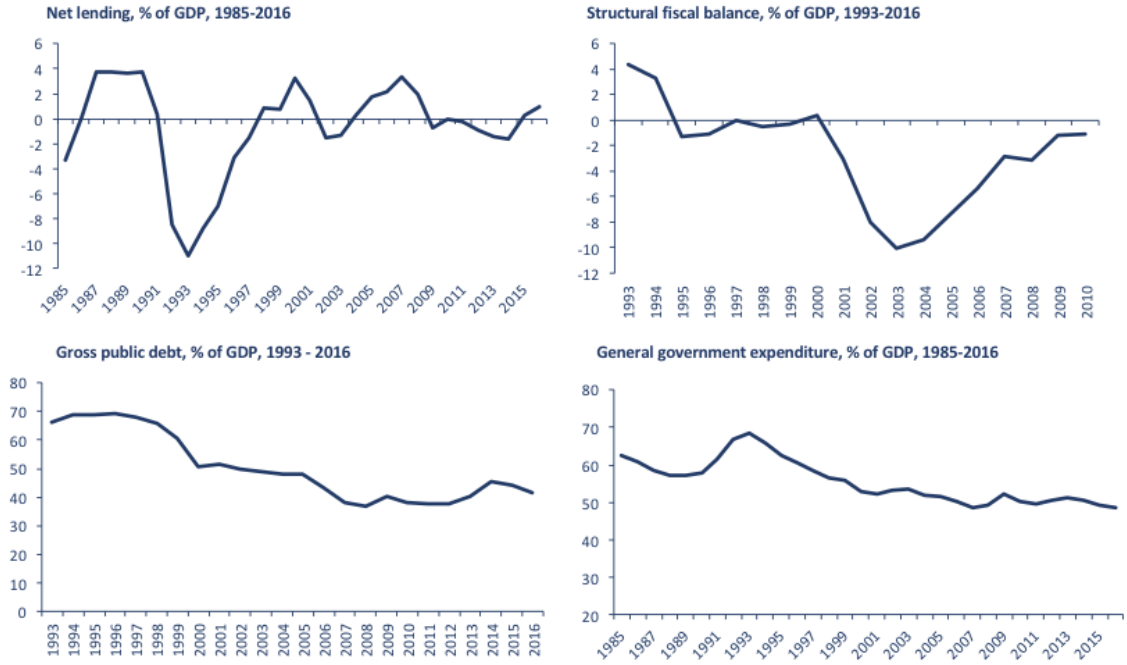
Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

Figure 7-10 – Finland responded aggressively to the fiscal crisis of the early 1990s; it is currently working to exert fiscal control in a low growth environment



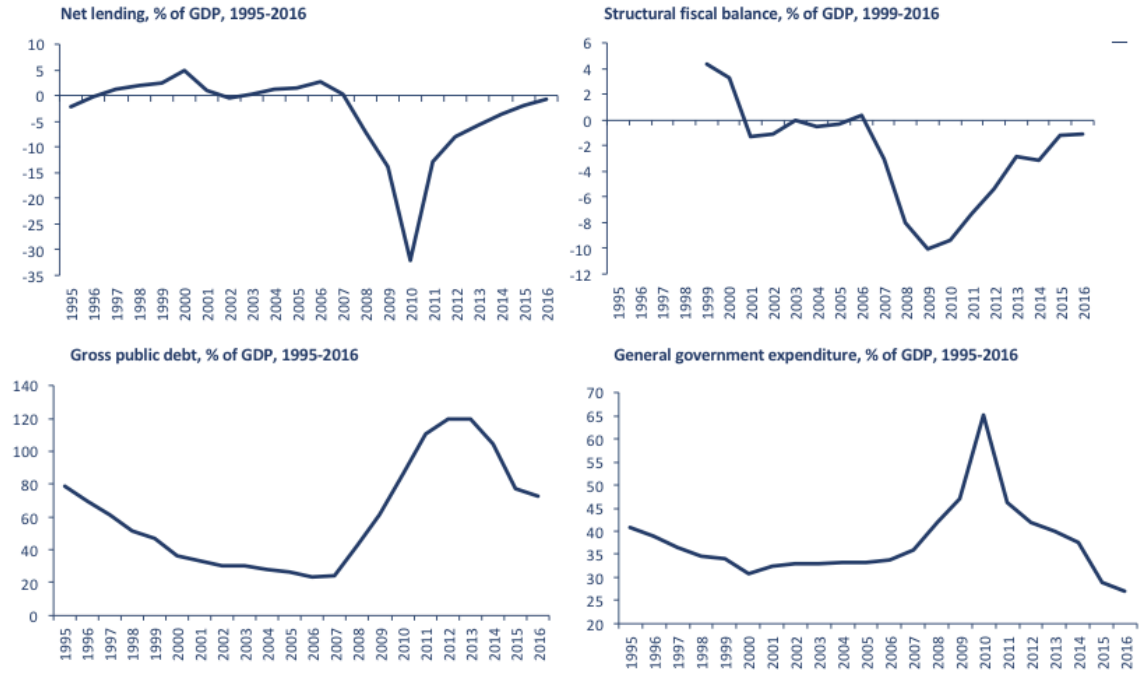
Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

Figure 7-11 – Sweden addressed a 10%+ fiscal deficit in the early 1990s, through tight expenditure control, robust GDP growth & strong fiscal institutions



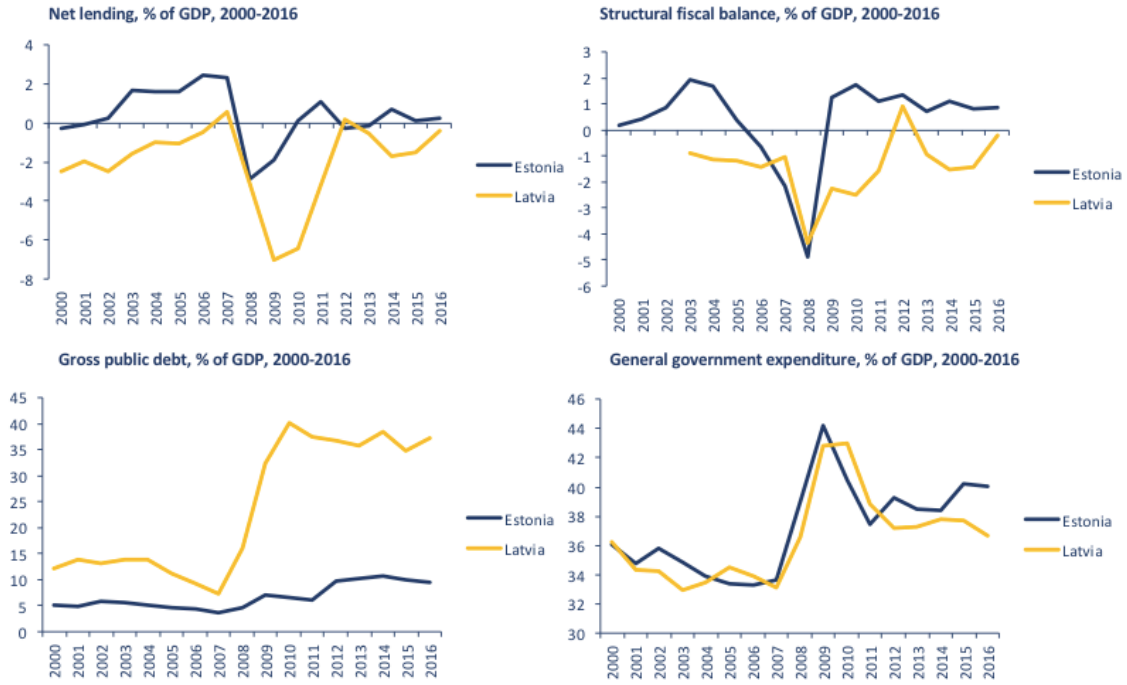
Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

Figure 7-12 – Ireland's strong growth has helped fiscally, although it led to structural loosening prior to the crisis. The post-crisis response was rapid



Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

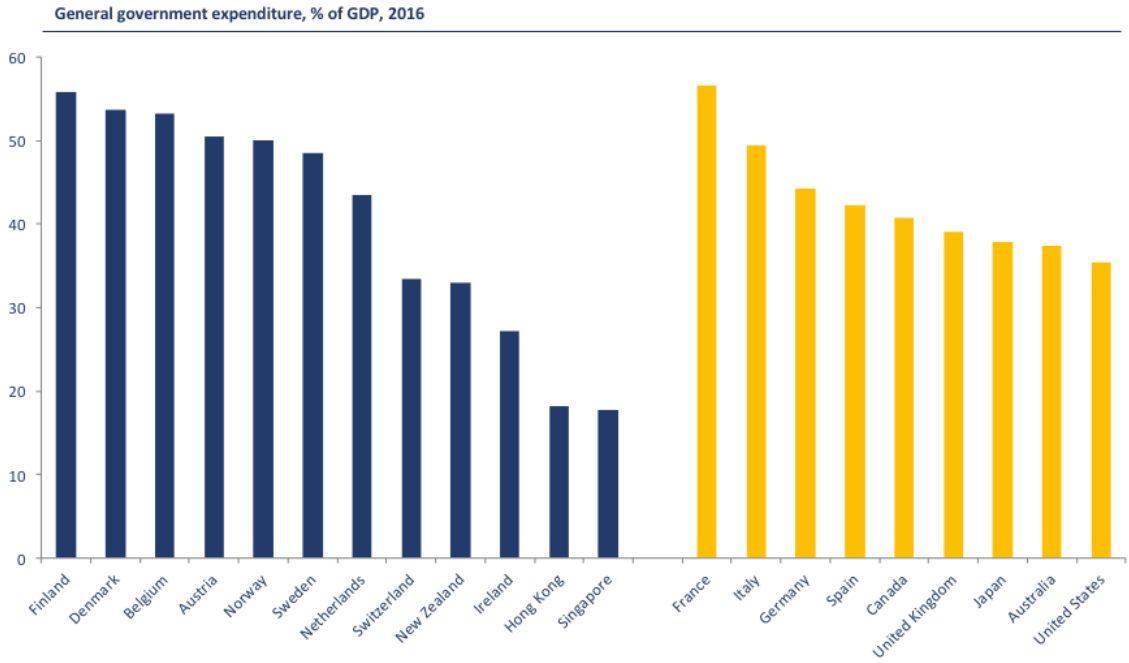
Figure 7-13 – Estonia and Latvia had a deep crisis experience, and responded quickly. Even so, Latvia accumulated a significantly higher debt stock but Estonia did not



Source: IMF World Economic Outlook, October 2017; Landfall Strategy Group calculations

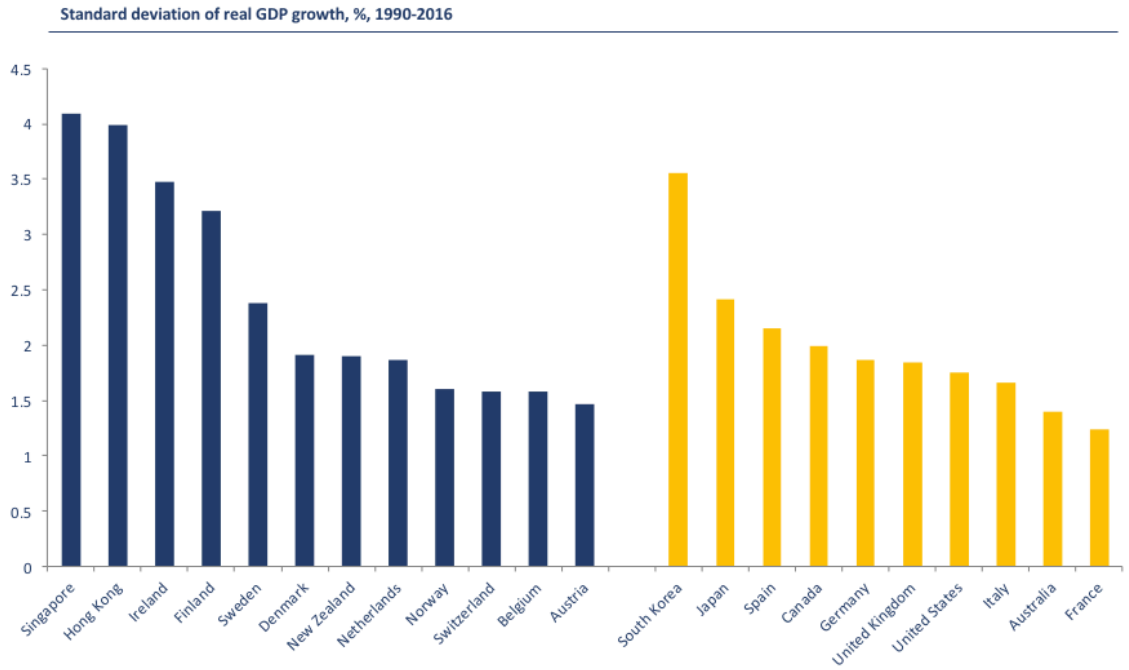
B7.15 Overall, small economies tend to be a more prudent in their approach to fiscal policy. A sustainable (desirable) level of public debt is lower in small economies than in large ones. The immediate implication for Scotland is that it should aim to be more prudent than the UK and that it has the opportunity to do this. Hence the debt targets identified in chapters 10 and 14.

Figure 7-14 – Several successful small advanced economies have high levels of government spending, although there is a wide distribution



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-15 – Fiscal policy needs to respond the higher level of growth variation that in small advanced economies, albeit on a plane of higher general performance



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

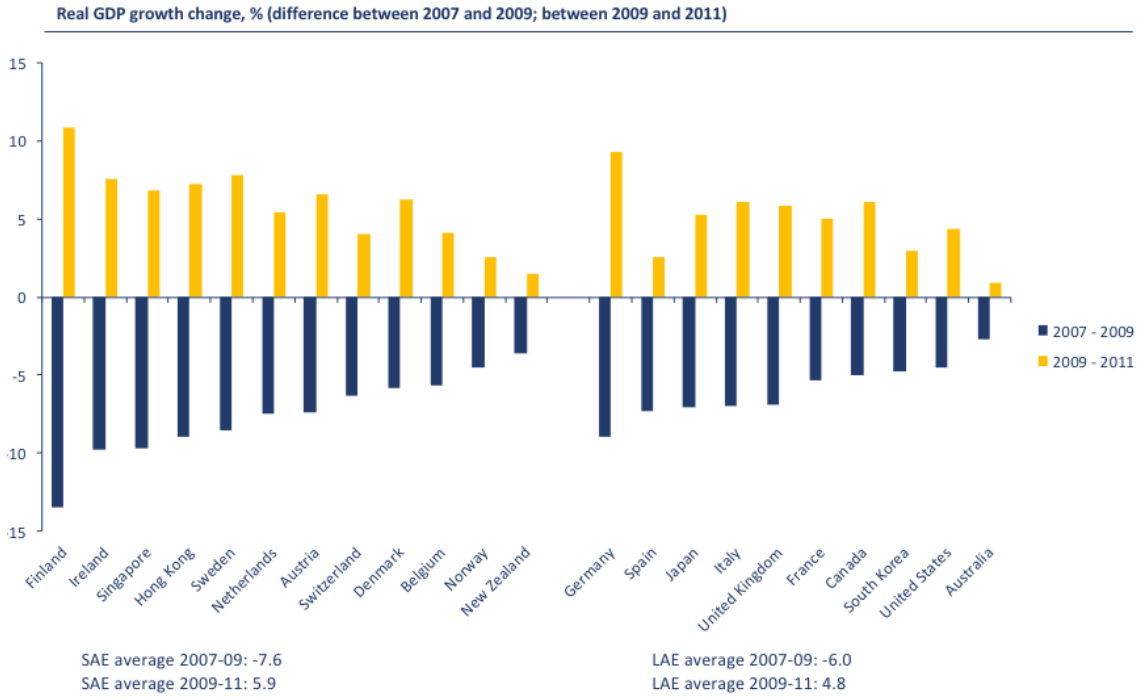
International Examples

B7.16 This section considers international experiences of *substantial* fiscal consolidations. These are defined differently in different studies, but a common definition is an improvement in the structural fiscal balance of more than 1.5% in a year, sustained for at least three years. There have been many examples of such consolidations, with a further increase in the number of fiscal consolidations over the past several years. And there are many instances of fiscal consolidations of a similar or indeed on a much larger scale to that facing Scotland.

B7.17 In a recent OECD study the average improvement was from a fiscal deficit of 7% of GDP to a fiscal deficit of 1% of GDP.

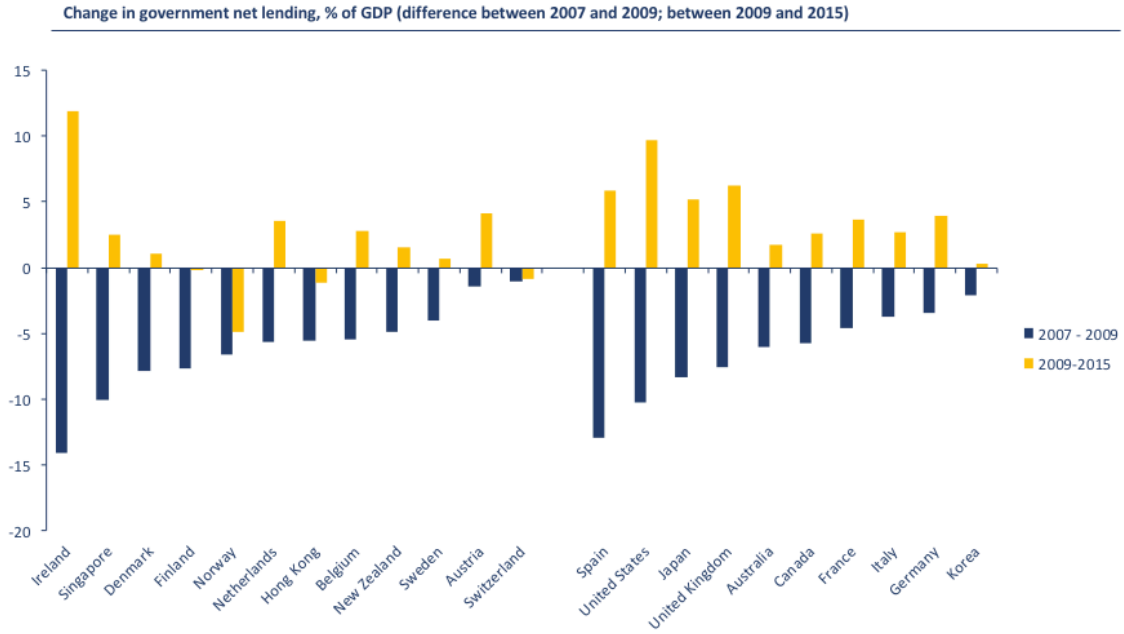
B7.18 This movement of 6 per cent is twice the scale of what is required to get Scotland from the actual inherited position that we anticipate (from just under 6% to under 3%).

Figure 7-16 – Many small advanced economies experienced a marked slow-down in growth rates during the global financial crisis



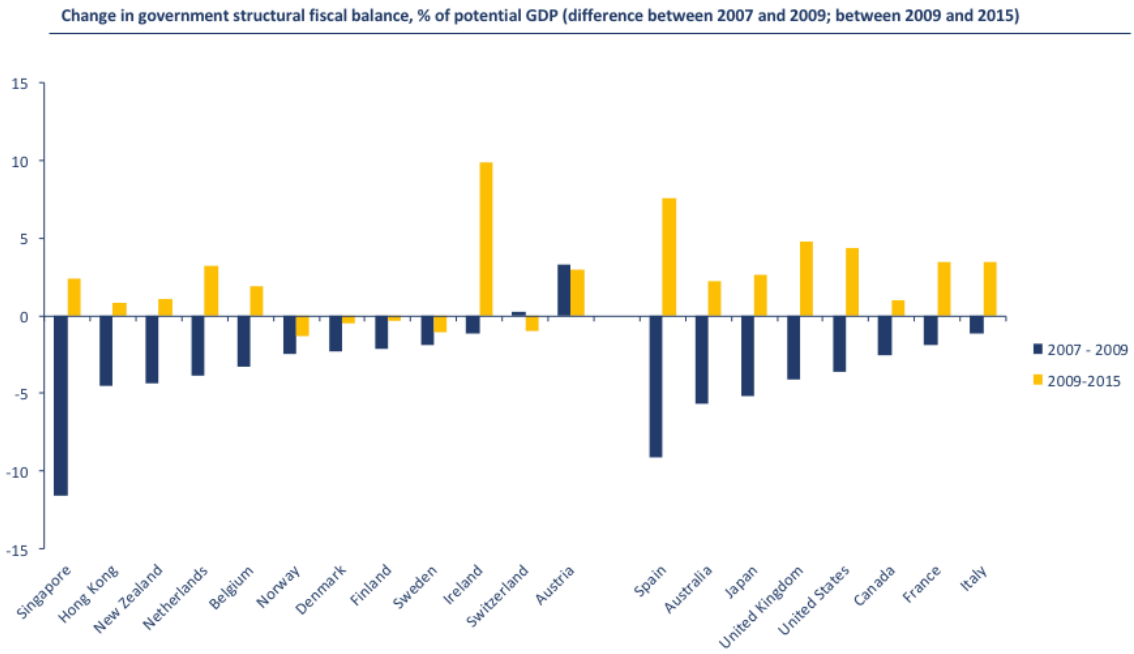
Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-17 – This contributed a substantial weakening in fiscal positions across advanced economies, with many still recovering (1/2)



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Figure 7-18 – This contributed to a substantial fiscal weakening in fiscal positions across advanced economies, with many still recovering (2/2)



Source: IMF World Economic Outlook, April 2018; Landfall Strategy Group calculations

Characteristics of deficit reduction programmes

B7.19 There are a few stylised facts that are instructive. With respect to the economic impact the consensus is that there is a significant multiplier effect from a fiscal consolidation; tightening

has a negative effect on the economy as the fiscal impulse reduces or turns negative. In bad times these multipliers can be quite large, and larger than in good times, which is why the economic impact of the process was under-estimated in several crisis countries. Scotland will need to be careful to tend to both the real economy and deficit reduction at the same time.

B7.20 However, this is not the universal experience – and there are periods of economic expansion at the same time as fiscal consolidation. The key factor in explaining these episodes is strong sources of external demand (and continued expectations thereof). Maintaining growth during periods of fiscal tightening requires a strong contribution from a key growth engine, which for small economies is almost certainly the export sector. This can be seen clearly in the post-crisis experience of countries such as Ireland and New Zealand which experienced relatively strong export growth (from currency depreciation coupled with cost restraints) over the relevant periods – supplemented by strong migration and inward investment.

B7.21 Roberto Perotti provides case studies of four small countries which undertook programme to improve their fiscal positions in the 1990s (Ireland, Denmark, Finland and Sweden). The key finding is that the countries that could sustain fiscal improvement were those that benefited from strong external demand; Denmark had relied on other sources of internal demand and was not able to sustain growth.

B7.22 This places the imperative of export led growth policies for Scotland to the forefront of thinking, as a key part of a strong, high quality economic strategy as set out in Part A.

B7.23 For a country, like Scotland the general credibility effect associated with efforts to improve the public finances is likely to be valuable. If a growth-oriented economic strategy is implemented at the same time then this will offset some of the economic effects of fiscal control.

B7.24 In general, for small economies returning to fiscal sustainability is a key priority. The challenge is to manage this process as effectively as possible. This is clearly a balancing act, given the economic impact of fiscal control and the different challenges and opportunities facing a newly independent country.

B7.25 The pace of the process should also have a clear view on overall timelines.

B7.26 Successful improvements in public finances have generally been structured with an emphasis on spending control relative to revenue growth. The empirical work consistently finds that deficit reductions that are successful, sustainable and have a modest impact on GDP, employment and investment tend to focus on spending control policies that are clear. The reason is to gain credibility in the markets for fiscal discipline, enough to secure investment spending and growth.

B7.27 Another contribution to improvements in the public finances is strong growth. However, deficit reduction requires more than growing out of a challenging fiscal situation; action is required.

B7.28 The IMF summarises the consensus on fiscal consolidation, noting that, "A gradual pace of fiscal adjustment will be credible only if embedded in a medium-term fiscal consolidation strategy buttressed by strong budget institutions. Other growth-enhancing measures, such as structural reforms, will be important to improve growth potential in the medium term and to help reduce the debt ratio durably. Where fiscal accounts are weaker and sovereign interest rates higher, the pace of adjustment will have to be more ambitious, bearing in mind the limits to social and political cohesion beyond which fiscal adjustment can be counterproductive." (Abbas et al. (2013)).

B8 SUPPORTING INSTITUTIONS: EVIDENCE FROM SMALL ADVANCED ECONOMIES

- The structure and design of fiscal policy and governance matters for both sustainable public finances and economic growth. We look to the evidence of successful small advanced economies.
- There are three supporting institutions that contribute: credible rules, targets and reporting; disciplined budget allocation processes; a structured approach to the government balance sheet.
- International evidence demonstrates that such institutions with respect for rules and targets can anchor expectations and build credibility. This is critical for creating sustainable and lowest cost funding of public borrowing.
- International examples are outlined in this chapter. Long term fiscal targets are recommended with clear guiding principles. A path for fiscal sustainability should be laid out clearly. Clear reporting and transparent accountability arrangements should be put in place.

B8.1 The sustainability of fiscal consolidation – and the extent to which it supports rather than hinders economic growth and does not compromise delivery of public goods and services – depends greatly on the way in which it is designed and structured and the values that drive any government or parliament. A strong set of fiscal institutions will support the consolidation, add credibility to the programme accelerating its impact, and allows for on-going fiscal discipline to be exerted.

B8.2 The international evidence shows clearly that the existence of strong institutions increases the probability of improvements in the fiscal position that can be sustained over time. Indeed, in many small countries, these institutions were established precisely to support such improvements (such as New Zealand, Australia, and Sweden).

B8.3 There are three types of supporting institutions that contribute to successful fiscal management:

1. credible aggregate fiscal rules, targets and reporting;
2. a disciplined budgetary allocation process; and
3. a structured approach to managing the government balance sheet.

B8.4 The OECD and IMF both consistently note that institutions with respect for fiscal rules and targets can help to anchor expectations, and build credibility. This is helpful for the domestic political economy, as well as in terms of capital market confidence. Countries that have credible spending or budget balance rules are more likely to stabilise debt and deficits.

B8.5 The benefits of deficit reduction can be eroded over time if there are not processes and institutions that can exert a degree of control and discipline to ensure on-going fiscal decision-making. It is here that a debt target, being a stock and therefore persistent, not an annual deficit flow, comes into its own. Once the sense of urgency or threat of a financial sanction passes because next year's deficit is a new deficit, the risk is that the government is unable to hold the line in terms of rigorous fiscal decision-making. It is not just a matter of controlling spending or raising revenues, but a way of sustaining this controlled decision-making over time. Ministerial commitment is a necessary but not sufficient condition; supporting institutions and processes are central to ensuring that improved fiscal outcomes are sustained.

B8.6 Countries with stronger budgetary processes were more successful in reducing debt. It is notable that countries that implemented stronger budget processes also had a better fiscal experience through the crisis (such as New Zealand). They could control spending growth more readily and restore fiscal sustainability. The European Commission also reports evidence that superior budgetary processes are associated with greater likelihood of successful improvements.

B8.7 A targeted approach is best to ensure a controlled fiscal improvement, for example through effective spending reviews. This helps contain future spending growth pressures. The premium is on securing productivity improvements in key categories of public spending so that the government can do more with the same level of resource.

Implications for Scotland

B8.8 There are two insights from this international experience that have direct implications for Scotland.

B8.9 First, a sustainable fiscal position is a strategic priority for small advanced economies. Fiscal sustainability matters more in small economies than in large countries; eventually large country fiscal positions need to be corrected, but they have a longer period in which to do so. For Scotland, as in other small countries, the willingness of capital markets to finance a fiscal deficit is a primary consideration. To secure that, Scotland will need to invest in building market credibility.

B8.10 Other small countries have achieved a return to fiscal sustainability (even in weak economic conditions) from a more challenging starting position than that facing Scotland. Indeed the Scottish 'go-ahead' debt position is far better than most countries and the deficit position, while challenging, is less stark than faced by many OECD countries at the start of such a process.

B8.11 Second, the history of achieving a position that is sustained and effective is that there are strong supporting fiscal institutions.

B8.12 Achieving an effective fiscal position is not simply a matter of making choices on spending and revenue. It is largely about having the institutional architecture that credibly commits

the government to a sustainable fiscal policy path, and that provides a robust and transparent basis on which to make choices. Because a substantial amount of the programme will likely come through controlling growth in the spending channel, it is crucially important to have secure and robust budgetary processes to guide these spending controls.

B8.13 Overall, fiscal institutions are central to the process of Scotland delivering a substantial, sustained improvement in its fiscal position. These institutions are also essential in steady state to ensure that the gains are locked in.

B8.14 These realities will place pressures on Scotland's fiscal decision-making: delivering a far-reaching reform in an economically coherent way and which does not compromise the underlying quality of public goods and services will be challenging but necessary under any constitutional position.

B8.15 It is in this context that we examined the international experience to understand the contribution that fiscal institutions can make, and the nature of a best practice system. The next three sections consider three key types of institution in more detail, to develop specific insights and guidance for Scotland: (i) aggregate fiscal institutions; (ii) budgetary processes; and (iii) government balance sheet management.

Aggregate Fiscal Institutions

B8.16 The first type of institution considered is the establishment of aggregate fiscal institutions to support the immediate process of fiscal improvement, and then to support an on-going exertion of fiscal control and discipline. This section provides a more detailed definition of these institutions; describes the international experience with respect to fiscal institutions, with a focus on small countries, and the associated evidence of their impact on fiscal outcomes; and draws out key implications for Scotland.

B8.17 Over the past few decades since the late 1980s, there has been a pronounced trend for developed economies to establish explicit fiscal frameworks to guide the government's overall fiscal policy approach. This was part of a broader movement of economic and public sector reform across many developed countries.

B8.18 But a key motivation for establishing these institutions was the common need to support fiscal consolidations, prevent them being needed again, and promote an understanding of the need to deliberately lean against the systematic tendency towards excessive debt accumulation. Debt enables the cost of current spending and investment to be shifted into the future. There is a large conceptual literature showing that governments face political incentives to defer spending cuts or tax increases, and to run fiscal deficits. This tendency led to steady increases in public debt levels across developed countries from the 1960s.

B8.19 Fiscal rules and institutions provide a discipline on these incentives to accumulate public debt, and to push fiscal costs into the future. They provide an overall trajectory for the process: what is the current state, what is the medium term desired steady state, and what

is the trajectory to get there? To the extent that this is done in a credible, best practice manner, it provides confidence in sustained good fiscal management. There is strong evidence that these institutions do make a difference for fiscal outcomes.

Defining Fiscal Institutions

B8.20 Fiscal institutions are intended to strengthen control over the fiscal position, in terms of the fiscal deficit and the accumulated stock of public debt. There are several core elements of a best practice set of fiscal institutions.

B8.21 The central element is to explicitly specify the medium term fiscal rules or targets (generally in terms of public debt, the fiscal deficit, and sometimes additional fiscal outcome measures) as well as the fiscal principles that will guide the fiscal path. This is accompanied by institutions designed to promote fiscal transparency (how often public reporting on the fiscal position and outlook is to be prepared), accountability mechanisms, independent economic and fiscal forecasting, and so on.

B8.22 This discussion describes these elements, using country case studies, and provides a summary of the consensus on what good practice looks like.

(a) Fiscal Rules and Targets

B8.23 At the core of fiscal institutions are numerical targets or guidelines. The IMF's Fiscal Rules Dataset shows that these fiscal rules focus largely on fiscal deficits and public debt, although some countries also specify rules and guidelines for the growth rate of spending and revenues. These fiscal rules emerged in the early 1990s, and have become increasingly widespread over the past 25 years (the IMF report that about 80 countries now have formal fiscal rules). Figure 8-1 (below) describes aspects of fiscal rules for selected small advanced economies.

B8.24 The IMF notes three key design principles for fiscal rules: a clear link to fiscal sustainability; flexibility in the application of the rule, so that the fiscal position can respond appropriately to shocks; and credible institutional sanctions for missing fiscal targets. The fiscal rules observed across most developed countries – and the case study countries discussed below – follow these design features. A key current debate is on how best to balance the need for fiscal stability against the importance of flexibility in a challenging economic environment.

B8.25 The international experience is that countries that have such fiscal rules and guidelines tend to generate stronger fiscal outcomes than those without. There is good evidence that these institutions helped to stop the increase in debt accumulation in many countries from the early 1990s. Once that happens, financing for future developments tends to flow.

B8.26 Another key contribution of fiscal institutions is to constrain the tendency towards 'pro-cyclical' fiscal policy - the tendency to tighten fiscal policy in bad economic times and to loosen fiscal policy in good times. This can generate economic costs, by amplifying the

magnitude of the business cycle, and often leads to debt accumulation over time (as fiscal policy is loosened more in good times than it is tightened in bad times). This tendency was observed in several countries in the decade before the crisis: for example, in New Zealand, Ireland and the UK. Fiscal institutions that extend the focus of decision-making across the business cycle can help to constrain this behaviour.

B8.27 There are two broad approaches to designing fiscal rules or targets: principles-based or a hard numerical target. In the 'principles-based' approach, the guiding principles for the conduct of fiscal policy are written into legislation – and it is then for the government of the day to specify exactly what this means in terms of the specific targets. Examples of this approach include New Zealand's Public Finance Act and Australia's (legislative) Charter of Budget Honesty.

B8.28 For example, New Zealand's Public Finance Act specifies the requirements of responsible fiscal management. Governments are required to specify a fiscal strategy that is consistent with several principles: to reduce total debt to prudent levels and achieve and maintain levels of total net worth so as to provide a buffer against adverse economic shocks; to ensure that on average total operating expenses do not exceed total operating revenues; to take into account the impact on monetary policy; to prudently manage the fiscal risks facing government; to have regard for present and future generations; and to ensure the nation's resources are managed effectively and efficiently.

B8.29 This allows for a degree of political flexibility, as governments can set the direction in a way that they think is appropriate. A key part of the value is to be transparent about the target and the objectives of fiscal policy. It means that the target is owned by the government, and can be adjusted to the prevailing economic context. For example, fiscal targets were adjusted after the crisis to reflect the more negative outlook. Of course, for such a system to work effectively, these rules need to be supported by political culture and norms to constrain inappropriate departures from sustainable fiscal policy. This should be done in a way that commands bipartisan support, so there are not major swings in fiscal policy approach.

B8.30 In this sense, these fiscal institutions are similar to the standard approach to monetary policy – in which the government specifies an inflation target (or similar objective) for the central bank in a public, transparent way, but is able to revise this target if it deems it appropriate.

B8.31 The second approach is a 'rules-based' approach of the type in the EU's Growth & Stability Pact. These specify a debt limit of 60% of GDP and a deficit limit of 3% of GDP. There are some provisions for flexibility, particularly in the event of exogenous events, which have increasingly been used since the crisis (although large countries such as Germany, France and Italy are more likely to receive this flexibility than small countries).

B8.32 The second design issue is how to specify the substance of these fiscal targets. Figure 8-1 has a listing of fiscal rules from selected small advanced economies.

Figure 8-1 – Fiscal rules in selected small advanced economies

Country	Over time (t0 – t10)
Denmark	Expenditure rule implies that real growth in public expenditures cannot exceed potential GDP growth. The Budget Act which came into force in 2014 introduces expenditure ceilings. The government targets a balanced structural budget by 2020. The annual structural public balance must not exceed a deficit of a ½ per cent of GDP at the time of the budget proposal for a given year unless extraordinary circumstances are present. Moreover, an automatic correction mechanism is activated in case of a significant projected deviation. EU rules.
Finland	There is a political commitment to achieve a substantial reduction in the debt-GDP ratio by the end of the parliamentary term. Moreover, the government is committed to adjust if the debt/GDP ratio is not shrinking or if the deficit stands above 1% of GDP. EU rules.
Israel	Public debt target of 60% of GDP. Spending growth is a function of achieving this target, with formal expenditure growth limits specified.
Luxembourg	Since 2004, public debt is to be kept at a level substantially below limits foreseen in the SGP. On spending, since 2010, the target is to bring expenditure growth back to the medium-term growth prospects once the countercyclical response to the crisis has been phased out. Under the "fiscal compact" signed March 1, 2012 the government commits to adopt a structural budget balance rule in its constitution as well as an automatic correction mechanism by 2014. EU rules.
Netherlands	Since 1994, real expenditure ceilings are specified for most classes of spending; EU fiscal balance and deficit rules
New Zealand	Maintaining rising operating surpluses (before gains and losses) over the forecast period so that cash surpluses are generated and net government debt begins to reduce in dollar terms; reducing net government debt to around 20 per cent of GDP in 2020 and, in the medium term, reducing net debt to within a range of 0 per cent to 20 per cent of GDP;
Norway	Since 2001, the non-oil structural deficit of the central government should reflect the expected return of the Government Pension Fund Global (GPFG),which is estimated to be 4%.
Sweden	Since 2000, a 1% fiscal surplus target over the cycle (measures by the average balance since the adoption of the target, a seven-year moving average, and the annual structural balance): expenditure growth targets; as well as the EU rules
Switzerland	Switzerland: Since 2003, the structural budget has to be balanced (one year ahead spending has to equal expected revenues, adjusted for the cycle). Any deviations included in a 'compensation account', that needs to be corrected when it exceeds 6% of GDP.

Source: IMF Fiscal Rules Dataset; European Commission Fiscal Rules Database

Debt Rule

B8.33 First, consider the debt rule. For small economies specifically, these debt rules are specified on the basis that high levels of debt impose economic costs (e.g. a higher risk premiums, which are damaging to investment), expose the economy to additional risks, and compromise growth and the ability to respond to cyclical or structural shocks. The greater volatility that small economies can experience also strengthens the case for fiscal conservatism – and setting the debt rule with a safety zone that allows shocks to be absorbed without breaching debt limits.

B8.34 The rule should reflect a level that is sustainable, recognising the potential for volatility as well as structural fiscal trends such as the fiscal costs of an aging population. For many small advanced economies, the national debt limits are adopted from membership in the EU (60% debt), although countries will often include additional guidelines and rules. For small countries outside the EU: New Zealand has a 20% net debt target and Israel has a 60% gross debt target.

B8.35 The OECD notes that debt targets should be designed to avoid overshooting the threshold in the case of an economic or other shock. Their model estimates around 15% for advanced economies: suggesting that for a debt ceiling of 60%, the debt target should be set at 50% of GDP or less.

Deficit Rule

B8.36 The fiscal deficit target should be set in a manner consistent with stabilising the debt level at or below the debt limit, while preserving a measure of flexibility to allow automatic

stabilisers to work. These deficit rules are specified in several ways: current balance (or including capital expenditure); the primary balance (excluding interest); or the structural/cyclically adjusted balance. And the deficit target can be specified at a point in time, or over a period (most frequently, over the business cycle). It can also be forward looking (based on an expectation of the current fiscal path) or backward looking (outcomes over the past several years); forward-looking rules can be more flexible (making subsequent consolidations less painful), whereas backward looking rules provide a tighter constraint and added credibility (particularly where the government has a deficit history).

B8.37 In general, deficit rules across the small advanced economies group adopt a business cycle perspective to the deficit target. Beyond this, there is significant variation in the specific design features. One consideration that has become increasingly apparent is that the design of the fiscal framework needs to be consistent with the monetary policy framework. Where independent monetary policy is constrained (for example, because of Eurozone membership, or because of pegged exchange rate), fiscal policy will undertake more of the stabilisation activity. The debt and deficit targets should reflect this.

B8.38 The other notable feature in many small advanced economies is the role of spending growth rules or limits, which are often framed in a way to ensure compliance with the overall fiscal rules and targets.

(b) Fiscal Transparency, Reporting, Accountability

B8.39 A second key element of fiscal institutions relates to the transparency of reporting requirements. This has been an area of significant progress over the past two decades. The standard definition of fiscal transparency is: "Openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities – whether undertaken inside or outside the government sector – so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implication." (Kopits and Craig (1998))

B8.40 There is a strong evidence base, using multiple datasets and methodological approaches, on the positive relationship between fiscal transparency and fiscal outcomes, even in the presence of strong fiscal rules or targets. The IMF's Fiscal Transparency Database documents a substantial improvement in fiscal transparency over the past two decades. This is associated with substantial and sustained improvements in fiscal outcomes in the aggregate. And within countries, the establishment of high quality fiscal transparency initiatives leads to improved fiscal outcomes over time.

B8.41 There is also evidence that fiscal transparency helps deliver high quality fiscal outcomes. For example, it prevents (or makes it more difficult) a government from hitting fiscal targets

through accounting tricks – and raises the discipline to ensure that the fiscal consolidation is real.

B8.42 The two key transmission mechanisms between fiscal transparency and stronger fiscal outcomes are higher-quality fiscal decision-making because there is better quality fiscal and economic information (and less chance of being surprised by fiscal risks, because the coverage will be more comprehensive); as well as added fiscal credibility, which helps with credit ratings, lowering the interest rates on government borrowing (and hence, in many cases, private sector borrowing). This will be the case also for Scotland while it establishes initial credibility with respect to its commitment to fiscal discipline.

B8.43 The IMF's Fiscal Transparency Database contains a listing of the various dimensions of fiscal transparency, and several researchers have constructed various measures of fiscal transparency (based on both IMF and OECD data). Small economies tend to rank well on these various measures, which is consistent with their general strong performance on measures of institutional quality, lack of corruption, and so on.

B8.44 Countries such as Australia and New Zealand provide good examples of fiscal transparency. New Zealand's Public Finance Act, for example, requires the Government to clearly state its fiscal policy objectives and the relationship between their policies and the principles of responsible fiscal management. Australia's Charter of Budget Honesty, passed in 1998, requires the Government to set out principles and requirements that guide the Government's management of fiscal policy (for example, to state its medium-term fiscal strategy, along with its shorter-term fiscal objectives and targets, and the accompanying economic and fiscal assumptions. It also has guidelines for costing policy proposals.

New Zealand's Public Finance Act

New Zealand's fiscal plans and objectives are presented in two key documents: The Fiscal Strategy Report and The Budget Policy Statement.

The Fiscal Strategy Report (FSR) is tabled in Parliament by the Finance Minister in advance of the budget. It states long-term (10 year) objectives for fiscal policy, including for the fiscal balance, operating expenses and revenues, the level of total debt and net worth; and explains how these long-term objectives accord with the principles of responsible fiscal management. If there is a deviation, this needs to be explained. The FSR also includes a statement of short-term (3 year) intentions on these variables (3 or more years); the consistency of short-term intentions with the principles of responsible fiscal management and long-term objectives, needs to be explained (and if there is deviation, the nature of the plan for return).

The Budget Policy Statement is normally tabled in Parliament in December by the Finance Minister, in conjunction with the December Economic and Fiscal Update. It focuses on the next budget (normally tabled in May). It is required to state the broad strategic priorities for the forthcoming budget including overarching policy goals, policy areas and consistency with the most recent short-term fiscal intentions. It also needs to explain any changes in the long-term fiscal objectives, or short-term fiscal intentions, and their relationship to the principles of responsible fiscal management. The goal is to avoid 'budget surprises' and allow time for debate before the Budget document is tabled.

Alongside this reporting, the Government is required to prepare regular economic and fiscal updates. There is the Budget Economic & Fiscal Update, a mid-year December Economic & Fiscal Update, as well as a Pre-Election Economic & fiscal Update (released around a month prior to a general election).

(c) Independent Fiscal Institutions

B8.45 Another form of external scrutiny is through independent fiscal organisations, such as fiscal commissions or fiscal advisory councils. There has been a rapid increase in these independent institutions, which are established by government to provide an additional check on fiscal policy decision-making (and indeed are now required by the IMF and EU Commission before any official loan programmes can be agreed). This is partly a response to concerns that many governments had made strategic policy mistakes (sometimes self-interested), and that additional institutional 'checks and balances' were required to ensure disciplined fiscal policy decision-making (for example, Ireland and the UK before the crisis). However, in countries such as The Netherlands, Sweden and Denmark, these agencies have been around for decades.

B8.46 Fiscal commissions are designed in many ways, often reflecting the specifics of local institutional and political context. Some agencies provide advice to the government on fiscal policy settings (Denmark, Sweden); others have a role in passing public judgement on the fiscal policy approach, such as whether it is consistent with meeting fiscal targets (Ireland); and some are involved directly in preparing economic and fiscal forecasts (The

Netherlands, the UK). Designed well, these can add to the credibility of fiscal policy, as well as the overall quality of the debate around fiscal policy.

B8.47 In 2013, the Fiscal Commission Working Group in Scotland recommended the establishment of a Fiscal Commission in Scotland. They noted that such a Commission would contribute to increasing the quality of public debate, increasing the credibility of fiscal policy by policing the extent to which fiscal policy settings were consistent with fiscal sustainability (and stated fiscal targets). A Scottish Fiscal Commission was created in 2014, but it has been restricted to forecasting the revenues from the four devolved taxes without commentary on budget sustainability.

B8.48 The evidence on these Commissions is mixed. They are generally seen as a useful addition, particularly when they include independent, respected experts. However, international reviews of these independent fiscal institutions consistently warn that they should not be regarded as 'silver bullets' – and it is not clear that they have led to significant changes in fiscal decision-making (over and above fiscal targets, broader fiscal transparency, and other sources of political and market discipline). They are better seen as a complement to existing institutions.

B8.49 Indeed, independent fiscal councils often struggle to compete with political realities. For example, Ireland's Fiscal Advisory Council, established in 2011, and comprising five academic economists (with a small secretariat), has a mandate to assess the macroeconomic and budgetary forecasts produced by the Department of Finance; to assess whether the fiscal stance of the Government is conducive to prudent economic and budgetary management with reference to the EU Stability and Growth Pact; and to monitor and assess compliance with the budgetary rule as set out in the Fiscal Responsibility Act.

B8.50 However, although the Council has good people and does good work, its statements of concern about government budgets seem to have had relatively limited impact on the fiscal decision-making process. Over the recent past, the Council has consistently pointed to the risks of overly loose fiscal policy, with which the government has chosen to disagree.

B8.51 One specific function of independent agencies that is also relevant to Scotland is the preparation of the economic and fiscal forecasts used in the Government's budgeting process (and to an extent for the costing of policies announced, including in election season).

B8.52 There is a well-documented tendency of systematic bias towards over-optimism in fiscal and economic forecasting, with consequent deficit bias. This is particularly true in good times, and when the fiscal position is closer to breaching the threshold (e.g. the 3% deficit limit in the EU). This leads to a need to subsequently make painful adjustments. In 24 countries, Jeffrey Frankel identifies a 1% bias in fiscal forecasting at a two-year horizon and a 2% bias at a three-year horizon (higher again in the 17 Euro-economies). If governments set policy on flawed forecasts, otherwise strong fiscal rules and budget processes may not be sufficient to generate strong fiscal outcomes.

B8.53 There are different models for building independence in forecasting to reduce this systematic basis. For example, New Zealand does this internally in the Treasury, which is a credible forecaster and is fully (operationally) independent of government. It also has established an external review process of these forecasts, to ensure that it is best practice. Many Finance Ministries rely on independent scrutiny of the quality of fiscal forecasting by technical experts, as well as markets and other researchers.

B8.54 Another model is to establish an independent economic and fiscal forecasting agency; such as the Central Planning Bureau in The Netherlands (established in 1945) or the Office of Budget Responsibility in the UK (established in 2010).

B8.55 The UK's OBR was established because of concern about optimism bias (and political influence) with respect to the UK's fiscal forecasts and the way in which the business cycle was defined, which allowed for a significant weakening in the UK's fiscal position prior to the crisis. The OBR has four main responsibilities: to produce (five year) forecasts for the economy and public finances (contained in its Economic and Fiscal Outlook published twice yearly); to judge progress by the government towards its fiscal targets and the likelihood that they will be achieved; to assess the long-term sustainability of the public finances; and to scrutinise Treasury's costing of Budget measures. But it may not comment on the likely effectiveness of those policies.

B8.56 The CPB in the Netherlands has a wider role, also conducting simulation of the Government's fiscal policies, their likely impacts and costs, and to consider the advantages of various alternatives in discussion with Cabinet members in the Social and Economic Council.

(d) Long-term Fiscal Forecasts

B8.57 Longer range forecasts have become more widespread over the past decade or so as more countries have recognised the potential fiscal impact of an aging population (such as old age pensions, health care spending). The expected spending and tax profile over the next decade associated with these structural trends may have an impact on the way in which fiscal policy should be approached today. For example, should governments run fiscal surpluses to save for these future costs – rather than raise taxes or cut other spending at the time? This is a choice about well-designed fiscal policy, but is also an issue of intergenerational equity.

B8.58 Fiscal policy decisions should be informed by clear data on the likely strategic context. In New Zealand, there is now a legislative requirement to supplement existing fiscal reporting with a long-term fiscal update (a 40- year horizon) with formal projections at least every four years. The aim is to better allow fiscal policy to be adjusted smoothly over time in response to emerging fiscal pressures. Similarly, Australia's Charter of Budget Honesty has recently been amended to include a requirement for intergenerational reporting (reflecting Australia's exposure to the fiscal costs of an aging population). These reports have a 50-

year horizon, and are required to be prepared and published every five years. The first of these reports was released in 2002.

B8.59 Given the inherent uncertainty associated with long-term forecasting, these will be heavily assumption-based (growth rates, oil prices, interest rates, and so on), and will often contain several scenarios with a range of possible fiscal outcomes.

Implications for Scotland

B8.60 An independent Scotland would need to act purposefully to establish fiscal sustainability and credibility. For Scotland, there are three key elements of an approach to establishing fiscal institutions that will support a credible, effective improvement in the fiscal position. These institutions will also provide the basis for on-going strong fiscal management in a sustainable, steady state situation, once the initial phase has concluded.

(i) Long-term Fiscal Target, with Clear Guiding Fiscal Principles

B8.61 The first task would be to define an overall fiscal anchor for the process, which would be guided by a definition of fiscal sustainability. As a start, this would involve a target for the public debt/GDP ratio and fiscal balance limits.

B8.62 The overall anchor for fiscal policy should be defined in terms of a stable level of gross debt at or below a sustainable level. There are two points of reference from the international experience to suggest a long-term debt target for Scotland.

B8.63 First, the debt limit in the EU's Fiscal Compact (60% of GDP) is a useful starting point. Ensuring that Scotland holds to meeting this minimum standard has several advantages. It is an understandable target (for the public and by markets), it is consistent with Scotland's aspiration for EU membership, and it is a fiscal rule that is used by many other small advanced economies in Europe. To convert this threshold into a target, it is important to recognise the fiscal and economic situation faced by small economies. Based on the OECD's work, a 'buffer' of 10-15% of GDP is appropriate to ensure that this 60% threshold is not breached. As a first approximation, this suggests a fiscal target of public debt of 50% of GDP or less.

B8.64 The second perspective is to look at current public debt levels of small advanced economies. The median of this group is currently 54% (with Singapore removed, because its gross debt does not reflect its underlying fiscal position), and with several countries still undertaking fiscal consolidation efforts to further reduce debt levels. This is consistent with a debt target of less than 50%. There is not much that can be gleaned from the international small country experience with fiscal rules. Most small advanced economies are subject to EU rules. Of those that are not, Singapore and Hong Kong do not have debt targets, Israel has a 60% debt target, and New Zealand has a net debt target of less than 20% of GDP.

B8.65 Overall, specifying a medium-term target for debt to be stable at 50% of GDP or less is a reasonable target for Scotland. This is broadly consistent with the analysis of the Fiscal

Commission Working Group in 2013. 60% should be regarded as the upper limit or threshold that should not be exceeded. Focusing on a 50% debt target will also assist in the process of strengthening Scotland's fiscal credibility, and it is very reachable.

B8.66 Once longer-term forecasts are made (which need not be an immediate priority), the debt target may need to be adjusted to reflect any demographic related challenges. For example, pre-funding of these future costs may be required – which may imply deliberately reducing debt now in expectation of a rising debt profile in the future as the population ages.

B8.67 In terms of the fiscal balance target, the target should be specified in a manner consistent with maintaining a debt track under 50% of GDP. This is contingent on the GDP growth rate, interest rates, as well as the desired buffer against shocks. If a 2% GDP growth rate can be sustained, then a deficit limit of around 1% of GDP may be appropriate in the longer term. If the growth rate is expected to be lower, then it may be appropriate to target fiscal balance over the business cycle. Conversely, a stronger GDP growth rate may allow for a slightly higher deficit target.

B8.68 Specifying a relatively conservative fiscal deficit target is important in providing space for counter-cyclical policy to be deployed. If a higher deficit target is specified there is limited space for additional fiscal stimulus in the event of a negative shock. It is better to be more prudent in normal times to allow for more effective counter-cyclical fiscal policy to be used in bad times. A more conservative target is also appropriate because the international experience cautions that fiscal 'slippage' is likely (because of the bias towards over-optimism); one response to this is to aim for a tighter fiscal balance target.

B8.69 Over time, the definition of fiscal balance should be extended to a broader balance sheet perspective (so that nothing is off-balance sheet from a budgetary perspective). This would also have the advantage of including depreciation costs, so that capital expenditure is smoothed out over time.

B8.70 Expenditure targets are not necessary as part of the long-term fiscal objective, although they may play a valuable role in providing budgetary discipline in a shorter-term sense. Figure 8-1 notes that many small advanced economies have expenditure growth rules or targets to ensure that fiscal decision-making remains consistent with overall fiscal targets. Scotland should follow this lead.

(ii) Laying Out a Clear Path for the Fiscal Recovery

B8.71 The critical challenge is moving from Scotland's starting fiscal position to this targeting of sustainability. To anchor the process – for markets, for domestic political purposes, and for budget planning purposes – it is important to have a clear, credible fiscal trajectory planned.

B8.72 This should move with pace, aiming to achieve a sustainable fiscal position within 10 years. This timeline is necessary to ensure consistency with EU fiscal rules, as well as recognising the limits with financing fiscal deficits of anywhere close to the current level.

B8.73 This path should be clearly laid out and progress reported. The pace of the fiscal consolidation should be measured through the deficit/GDP ratio, moving from the starting point to a stable level of under 3% of GDP initially and then in a steady state maintaining the Debt/GDP ratio below 50% and balancing the deficit over the course of any cycle or with a relatively small deficit level running lower than GDP growth over the cycle.

(iii) Clear Reporting, Transparency, Accountability Arrangements

B8.74 An important way of establishing the credibility of this process is through a strong set of accompanying fiscal institutions. There are three priorities in this regard.

B8.75 First, the guiding fiscal principles, the long-term fiscal target, and the proposed fiscal consolidation profile should be embedded in clear institutional architecture, together with robust arrangements for fiscal reporting, transparency, and accountability.

B8.76 As in countries such as Australia this is a principles-based approach that requires the government to outline its fiscal targets and policy approaches, and then to report against these. There is a clear sense of what good practice looks like in this regard, and so these institutions could be established very quickly. The New Zealand legislation could be used for these purposes, for example. There are clear advantages in using a respected, understood approach, and committing to use this structure in the same way that other high performing countries do.

B8.77 This would also prescribe the nature of comprehensive fiscal reporting – with clear statements of the strategy, priorities, responses to emerging issues, and so on. It would require the government to clearly articulate the path towards improvement and to regularly explain any deviations. This would add to the credibility of the process through establishing a legislative framework. These institutions build credibility by increasing the reputational and political costs of departing from core principles or guidelines (and provide benchmarks against which the government's performance can be measured).

B8.78 Second, a credible fiscal improvement process needs to be built on well-respected economic and fiscal forecasts that are produced in an independent way. The data used need to be trusted, and there should be a disciplined process for assessing the fiscal consequences of various policy choices.

B8.79 Although many countries undertake this function internally (within a Finance Ministry), there is a well-documented tendency towards over-optimism in fiscal forecasts. Particularly for a Scottish Government setting out to deliver a demanding fiscal consolidation, it is important that the economic and fiscal forecasts are understood to be highly credible. The Scottish Parliament recently established the Scottish Fiscal Commission to produce economic and revenue forecasts. With independence an expansion of the functions of the SFC should be considered alongside the establishment on independent National Statistics bodies to produce market sensitive statistics and to enhance Scotland's statistical capacity. In addition to independence of operations and governance the SFC and any future Statistics body needs to have respected capability.

B8.80 Third, over time, the establishment of an independent fiscal institution could be considered (along the lines recommended by the Fiscal Commission Working Group in 2013). However, the establishment of an expanded Scottish Fiscal Commission is better seen as a complement rather than as a primary measure. Although these groups can play a useful function in the public debate, as noted above, the evidence is not persuasive that they can provide a strong role in delivering an immediate improvement in the public finances. Clarity and transparency around the target and the trajectory, together with an independent economic and fiscal forecasting capability, as well as scrutiny from Parliament, the public and markets, should provide a sufficiently credible commitment.

Establishing the Institutions

B8.81 Scotland has existing fiscal processes and institutions. But these should be further developed to ensure they are high performing. Building additional fiscal credibility through fiscal institutions would also allow for a more gradual process of fiscal consolidation, which would have clear economic and fiscal benefits.

B8.82 Not all these institutions can be established immediately. Some would take several years to be fully developed. The immediate focus should be on establishing the institutions that provide credibility (fiscal rules, independent reporting, a centralised budget process), and to gradually build the supporting infrastructure (performance based budgeting, spending reviews, fiscal commissions, and so on).

B8.83 Together with developing a robust economic strategy that can strengthen Scotland's growth profile, building a high-quality set of financial institutions will be critical for Scotland's sustained economic success.

B8.84 Much of the institutional structure can (and should) be implemented pre-independence within existing rules or early in any transition process. There are several reasons:

- establishing some of these institutions and processes takes time, and it is important to get the design choices made, to build capability, and overcome teething problems/issues prior to independence;
- these institutions can add value in the current state in terms of strengthening the fiscal outcomes; and
- the existence of such institutions will provide a signal of commitment to fiscal credibility in the context of an independence referendum (communicating that Scotland is putting in place high quality fiscal institutions, drawing from international best practice).

B8.85 A fiscal institutions framework that can be put in legislative form (perhaps something like the New Zealand approach) should be developed: fiscal policy guidelines/principles, accountability, reporting and transparency requirements (e.g. that the government tables a fiscal strategy). This could be implemented now.

B8.86 An independent agency that would have responsibility for producing economic and fiscal forecast will be required, building on the Scottish Fiscal Commission. Again, this could start with a more limited role, providing economic and fiscal forecasts to the government based on the current set of powers and expanded on independence.

B9 BUDGET PROCESS

- Robust budgetary decision-making is a necessity for meaningful government control over fiscal aggregates. The international evidence demonstrates that the budget process matters.
- Evidence suggests that the budget process is at least as important as the rules themselves.
- Small advanced economies perform better on OECD measures of high performing budget processes than large economies. There is increasing consensus on best practice across developed countries.
- The Scottish Government should aim to strengthen the decision making process, increase the quality of resource allocation and consider new tools such as a systematic process of structured spending reviews across major spending areas, bottom-up. The best performing countries (such as Denmark) should provide the benchmark.

B9.1 The fiscal institutions described above provide the overall parameters or guidelines for fiscal policy. The annual budget process takes place within these parameters, to allocate resources and to raise revenue in a manner consistent with the fiscal balance targets. Institutions to support the budget process can ensure high quality budgetary decision-making, guaranteeing that the overall resource allocation achieves the best outcomes possible. Budgetary institutions focus on ensuring that the various spending decisions align with the overall fiscal targets, align resource allocation decisions with strategic priorities, and efficiently convert resources into outcomes ('doing more with less', driving efficiency and productivity improvements in government agencies).

B9.2 Without a robust budgetary decision-making process, governments will not have an ability to exert meaningful control over fiscal aggregates. The international evidence shows clearly that budget processes have a strongly positive effect on fiscal outcomes. And this research suggests that these budgetary procedures are at least as important for delivering good fiscal outcomes as fiscal rules. It is not possible to achieve a sustained improvement in the fiscal position through non-discriminating spending cuts. Given the nature of the challenge in Scotland, a robust set of budgetary institutions and procedures will be a critical complement to strong fiscal rules.

B9.3 The OECD has a database on budgetary institutions which describe the key elements of a high performing set of budgetary process elements. Small advanced economies tend to perform well on these measures. And significant progress has been made in these areas in many small economies over the past decade or two. There has been a general convergence in budget processes and institutions across developed countries over the past two decades based on increasing consensus as to what good practice looks like. This section will describe the specific experiences in several selected small economies, as well as summarise the international evidence on best practice.

Defining Budget Institutions

B9.4 There are several key components of a high performing set of budgetary institutions:

1) decision-making process: specifically, the role of the Finance Minister relative to spending Ministers

2) clarity around resource allocation: the ability to identify strategic priorities, to allocate resources to key results (performance based budgeting), and with robust accountability and reporting

3) specific tools and instruments to improve the quality of resource allocation, such as spending reviews and benchmarking and scrutiny by Parliament and others including Audit Scotland

Decision-making Process

B9.5 There is well-developed literature on how different systems of budgetary decision-making impact on fiscal outcomes and on the quality of government spending. One of the central insights is that the greater the number of decision-makers, the worse the fiscal outcomes are likely to be. A more decentralised decision-making system will generate worse outcomes in terms of discipline because the individual decision-makers do not face the full costs of the decisions and the accountability is diffused across many parties (the 'common pool resource' problem).

B9.6 There is strong empirical evidence to this effect. Many studies have established that fragmented budgetary decision-making caused by a high number of spending ministers leads to higher spending and deficits in OECD countries, as well as in emerging markets. There is also a large body of evidence that shows that centralised budgetary decision-making (e.g., a dominant role for the Minister of Finance) contributes to lower deficits. In addition, more centralised, hierarchical processes – with a strong role for the Finance Minister – also constrains the tendency towards pro-cyclical fiscal policy (in decentralised budgetary systems, it is more challenging to exercise fiscal restraint in good times).

B9.7 The evidence is that a central role for the Minister of Finance in the budget process makes a significant contribution to fiscal performance. A clear allocation of budgetary responsibility to the Minister of Finance contributes to better outcomes in several ways: by ensuring consistency of the decisions taken in the annual budget with the agreed fiscal trajectory (e.g. by administering a multi-annual spending rule that is based on the fiscal target); to fully internalising the costs of incremental spending decisions in a specific agency, by taking a whole of government view on spending; and to being able to make hard trade-offs in a consistent way across spending agencies. This centralised approach also makes it easier to respond quickly to economic and fiscal shocks.

B9.8 Unless aggregate fiscal institutions are supplemented with micro-level institutions, it will be hard to maintain the fiscal consolidation process, with the risk that a bottom-up budgetary process breaches the top-down targets.

Resource Allocation (Performance-based Budgeting)

B9.9 The second key element of budgetary process is the nature of the resource allocation process: the basis on which resources are allocated to competing demands across spending agencies. At a high-level, some systems focus on the quantity of resources allocated to various spending agencies (an inputs-based approach) whereas an outputs (or outcomes)-based approach focuses to a much greater extent on contracting for specific outputs or outcomes.

B9.10 The OECD notes that countries report the following benefits from performance-based budgeting: a sharper focus on results within the government; more and better information on government goals and priorities, and on how different programmes contribute to achieve these goals; a greater emphasis on planning that provides key actors with details on what is working and what is not; and improved transparency by providing more and better information to parliaments and to the public.

B9.11 The empirical link between the implementation of performance-based budgeting practices and superior aggregate fiscal outcomes is unclear, but there is a view in several governments that these practices are supportive of fiscal discipline. And it is helpful in securing the productivity improvements within government agencies that are necessary as citizen expectations of government continue to increase despite the existence of fiscal constraints. Overall, a system that allocates resources based on desired outcomes is likely to deliver better fiscal outcomes, as well as better public service outcomes.

B9.12 The supportive nature of a sharper, more granular resource allocation process is likely to be more pronounced in a period of extended fiscal consolidation. These tools will support a more focused process that reduces the risk of blunt spending cuts (e.g. across the board reductions). Organising the budget process around outcomes can be challenging, but the benefits make this a worthwhile investment. Indeed, over the past few decades, there has been a pronounced shift away from budgeting for inputs to outputs and outcomes. This was led by New Zealand and Australia in the late 1980s/early 1990s, and now has been more widely adopted.

B9.13 For example, in countries such as Denmark and New Zealand, there is an agreement with the agency head on the outcomes to be achieved given the resource allocation; and then an annual process for assessment and evaluation. This has led to a more results-oriented culture. However, recent comparative work by the Institute for Government described the weakness of performance management in the UK relative to other countries – suggesting that there may be scope for improvement.

B9.14 There is sizeable technical literature on implementing performance based-budgeting approaches. From this, it is possible to identify several key characteristics that provide the basis for designing a budgeting system organised around outputs or outcomes.

B9.15 First, a clear overall sense of medium-term strategic priorities to provide shape to the direction of the budget: which outcomes matter, how are these areas to be prioritised (including decisions on what the government is not going to do), and a view on the way in which increased resource allocation is likely to contribute to achieving these outcomes. For example, an increasing number of governments are preparing statements of key policy objectives against which progress is regularly reported – and which acts as an organising device for strategic resource allocation.

B9.16 Second, for resource allocation decisions for specific agencies, there should be a standardised requirement for a structured 'business case' that describes the way in which the increased spending is expected to lead to improved outcomes. This may include a requirement to identify existing areas of spending that are not effective, and which can be reduced. Agency leadership will commonly have an obligation to use their overall resource allocation to optimise delivery of public goods and services, which implies an on-going process of transferring resources from low to high productivity uses.

B9.17 Third, a process of holding agencies accountable for outcomes after the event. If spending agencies cannot demonstrate the way in which the increased resources have led to improved outcomes, it will be more difficult for them to bid for new funds in the future. An important key role for central agencies (particularly the Ministry of Finance) is to monitor and evaluate whether resources are being used effectively.

B9.18 This is not a hard science and causality is often difficult to identify. But a structured process of analysis can provide useful discipline on the resource allocation process. This would require investment in preparing more detailed financial and management information, including performance tracking.

Specific Budgeting Tools

B9.19 The annual budgetary process tends to focus on marginal spending requests rather than the full government spend. But to get improvements in productivity across the full government budget, new approaches are being used to improve the efficiency and quality of overall government spending. These are particularly useful both for a programme aimed at improving the fiscal position, as well as on an on-going basis.

B9.20 One good example is spending reviews which look at the overall spending within an agency or sector. During the crisis period, many governments undertook spending reviews (focused on key spending areas) to identify efficiency savings.

B9.21 The OECD categorises spending reviews as either functional in nature, focused primarily on improving the efficiency of existing programmes; or strategic reviews, which extend to prioritisation and look at what the government should and should not be doing. These

spending reviews are commonly led by the Finance Ministry, with the involvement of line agencies. There is now a well-developed view on how to structure these spending review processes effectively; they can be effective as devices to raise productivity in government.

B9.22 Spending reviews can also be integrated into the process of government budgeting. For example, the Finance Ministry in Denmark has a rolling programme of spending reviews, each taking 2-6 months, depending on the size and complexity of the scope. In a typical year, 2-3 reviews, each covering major parts of government spend, as well as 5-10 smaller reviews, are completed. The reviews follow a standard methodology of establishing cost baseline, estimating budget improvement potential based on benchmarks and bottom-up analysis, and developing specific actions to be taken to capture the identified potential.

B9.23 Governments are also using benchmarking approaches across government agencies to identify efficiency opportunities in key areas (particularly in support services, to free up resources for citizen facing services). In 2010, for example, central agencies in New Zealand launched BASS (benchmarking of administrative and support services) where agencies provided data on a range of functions on standardised dimensions (cost of office space, person per square foot, HR support ratios, and so on). This enabled best practice to be identified across the public sector, and for targets to be set for participating agencies. This process identified significant efficiency savings for under-performing agencies if they moved to the median or the frontier (of around 15-20%).

Implications for Scotland

B9.24 Scotland needs to achieve sustainable finances. Strengthened budgetary processes will be required to ensure that decisions with respect to resource allocation are made as effectively as possible.

B9.25 This discussion considers priorities for Scotland in terms of the three dimensions of budgetary process described above.

(i) Strengthen the Decision-making Process

B9.26 A priority is to have a well-functioning, centralised decision-making process that is led by the Minister of Finance. This must be supported by strong accompanying capability in the Ministry of Finance. There should be a tightly structured annual budgetary process, which allows time for both high quality decision-making as well as external scrutiny (including by Parliament).

B9.27 The agreed programme to achieve a sustainable fiscal position will generate a series of annual fiscal aggregate targets, which will vary over time, as economic and fiscal outcomes develop. This will provide a binding spending cap that will govern the annual budget process, in both the current year and for subsequent years. This will provide the frame for the budgetary process to be led by the Finance Minister.

B9.28 The priority task for the Minister of Finance is to conduct negotiations with the spending agencies. This should be informed by a clear statement of the government's strategic priorities, as well as by high-quality spending proposals from agencies, and a rigorous process of review of these proposals by central agencies.

B9.29 These budgetary processes should be implemented immediately. Scotland can take aspects of these processes from existing high-performing systems and adapt as appropriate to fit into the specific Scottish context.

(ii) Increased Focus on the Quality of Resource Allocation

B9.30 To an increasing extent, Scotland needs to adopt a more performance or outcome approach to budgeting. The focus should be achieving stronger results through spending, rather than having the quantum of spending as a measure of commitment. The fiscal challenges will create a need for a rigorous approach to prioritisation of government spending. Structures should be established to allow for prioritisation both at macro-level and at spending agency level. At the agency level, budget bids from agencies need to have a clear business case in terms of how the additional resource allocation will contribute to superior outcomes. This may include some ability to identify low value programmes that can be discontinued. This will likely involve some investment in building information systems and capability to undertake this process in a disciplined way. This can be developed over time.

B9.31 Systems will also need to be developed to allow for a stronger approach to the assessment and evaluation of various programmes: what is working, what is not, and how improvements can be made. This will take time, but it is central to ensuring that good outcomes can be generated.

(iii) Introduce New Tools

B9.32 As with countries such as Denmark, Scotland should consider implementing a systematic process of structured spending reviews across major spending items (to ensure that they remain aligned with government priorities, and that the spending programmes are efficient). Scotland has conducted spending reviews previously, but these do not seem to have been as granular (or bottom-up) as the systematic spending reviews that have occurred in other jurisdictions. There is much insight that can be taken directly from organisations such as the OECD, and from other governments, on the best way in which to structure these reviews.

Implementation

B9.33 Strengthening the annual budgetary process should also be done now – making any required adjustments to the current process (particularly, the role of the Minister of Finance in terms of decisions on the fiscal envelope, specific allocation of resources). This is a good thing to do pre-independence, to ensure high quality spending decisions.

B9.34 A structured spending review process of major spending categories (specify an approach and timeline to review major spending categories, agencies over the next several years) should be implemented. This is a 'no regrets' move, and would generate benefits under current arrangements. The scope of this process should be agreed, and accountabilities assigned.

B10 TAXATION SYSTEM: PRINCIPLES & STRATEGY

- Borrowing on the work of the Scottish Government's Fiscal Commission Working Group we highlight the issues and opportunities for the taxation system in Scotland and recommend further work.
- The decisions that are taken by government on the design of taxes and tax rates set should take account of the likely economic impact on the economy, including on behaviour of individuals and on businesses. This should include regard for maximising revenues, since increasing (or reducing) rates does not always lead to increased (or reduced) revenues; taxpayers can often change behaviour as a result of the changes made.
- A comprehensive review of the Scottish taxation system beyond income tax is recommended drawing on the best global expertise and experience with a review to recommending reforms to improve simplicity, neutrality and flexibility.
- A cross-partisan approach is sought.

B10.1 In this section we consider, only briefly, the strategy behind the taxation system and the principles that underpin it. It is not a core requirement of this Commission's work but some principles should, we recommend, assist the direction of further work and policy decisions from the Scottish Government.

B10.2 In 2013 the Fiscal Commission Working Group published "Principles for a Modern and Efficient Tax System in an Independent Scotland". That work stands largely as is, although further thought is needed to encompass subsequent changes to taxation and welfare policy and also to the broader economic context given the Brexit process and what we come on to recommend in subsequent work on Monetary Policy. The report considered the work of the Mirrlees Review of the UK tax system undertaken by the Institute for Fiscal Studies in 2010-11, the most comprehensive review of the UK system to date.

B10.3 The 2013 Fiscal Commission Working Group report said: "In looking at reviews such as the Mirrlees Review and the experiences of other countries, it is important not to pick individual elements to argue in favour or against the merits or demerits of a particular action. Such an approach would be partial, misleading and flawed. Any framework which looks across the entire system, by definition, needs to examine the totality of the proposition and the overall political, economic and social objectives trying to be achieved".

B10.4 This is a sound and balanced perspective and applies across the course of the entire Sustainable Growth Commission's systemic approach. Debates on welfare and taxation in Scotland have, in recent years, focussed on the margins of the overall strategy and without a reference to the principles underpinning the system. This has tended to be focussed on whether policy should implement what has been done at a UK level, or indeed mitigate it. Such a piecemeal approach referencing singular policy moves at only the UK level only would produce very sub-optimal policy for Scotland.

B10.5 We recommend that when considering taxation strategy and principles that the Scottish Government, and indeed all policy makers, give full consideration to the conclusions of the 2013 report. We also recommend further that:

1. That for the transition period, stability, certainty and predictability will be especially important and policy must be set as part of the overall sustainable economic growth strategy.
2. Due consideration must be given at all times to the impact of any moves on behaviour and incentives and therefore on revenues and the health of the tax base. Increasing (or reducing) rates does not always lead to increased (or reduced) revenues, since taxpayers can change behaviour as a result of changes made.
3. Actively increasing the size and health of the tax base and optimising revenues should be a priority. Lessons should be learned and acted upon purposefully. One of the core advantages of small advanced economies is the ability to act quickly and purposefully.
4. A comprehensive review of the Scottish taxation system should be established which draws on the best global expertise and experience. This review should report to Parliament the opportunities for reforms to the system that will improve its simplicity, neutrality, stability and flexibility – the principles noted below. A cross-partisan approach should be sought to setting the longer-term framework and strategy that will therefore stand the test of time.

Key Conclusion from Fiscal Commission Working Group 2013 Report

Independence would provide a unique opportunity to develop a modern and efficient tax system. If Scotland was to get it right, it could be used as a powerful tool to grow key areas of the economy and tackle longstanding weaknesses. An efficient system could be a major international competitive advantage for Scotland supporting more investment, jobs and growth.

Establishing such a system will be challenging and should be phased over time. However, the benefits of moving to such a system will undoubtedly pay off in the long-run.

Past decades have seen an increasing level of complexity of the UK tax system. The administration costs associated with tax collection in the UK are higher than in many competing countries. According to the OECD, administrative costs in the UK amounted to 0.73% of all tax revenues in 2013, compared to 0.29% in Switzerland, 0.39% in Sweden, 0.41% in Norway and 0.47% in the United States[33]. Additionally, the UK has a significant 'tax gap' with the latest official data from HMRC estimating this to be £36 billion in 2014-15, which is 6.5% of theoretical tax liabilities[34]. The 'tax gap' is the difference between the quantity of tax that should, in theory, be collected by HMRC, against what is actually collected.

Independence would grant Scotland full control of all tax revenue and expenditure levers with autonomy over tax design, collection and implementation. It would offer a unique opportunity to design a modern and effective taxation system that was not burdened by historical legacy and years of adjustments, which result in complexity, cost and confusion. Scotland would be able to re-examine the entire tax framework and to design a system based upon specific Scottish circumstances, preferences and principles, while incorporating modern technology to minimise administration costs.

Scotland would have the opportunity to design a new tax system built around Scottish circumstances and preferences. Scotland would need to build skills and capacity over a transition period, supported by, in all likelihood, the use of short-term shared service agreements for instance. It would have the opportunity to communicate clearly and early the direction of travel it intended to move – and the principles it would base the system on.

The Scottish Government would be able to build upon the capacity and lessons learnt from the implementation of the tax powers in the Scotland Act 2012 and Scotland Act 2016 and the establishment of Revenue Scotland to assist with the transition and implementation of new powers.

[33] Tax Administration 2015: Comparative Information on OECD and other advanced and emerging economies (OECD 2015) Table 5.4, Page 181

[34] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf

Principles of a Taxation System

B10.6 The principles for an effective taxation system are well established and were set out by Adam Smith in the Wealth of Nations, first published in 1776. He proposed four maxims that a fair tax system should abide by:

- Equity: "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."
- Certainty: "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person."
- Convenience: "Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributors to pay it."
- Efficiency: "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."

B10.7 The report on by the Fiscal Commission Working Group set out principles for a modern and efficient tax system in an independent Scotland, which remain valid:

1. Simplicity: "A simple tax system is one in which tax rules and obligations are well known, easily understood, and where liability is clear. With a simple tax system, taxpayers can anticipate in advance and factor into their decision making, with minimal burden and uncertainty, the tax consequences of an action. Simple tax systems improve transparency – and in turn political and administrative accountability. Easily understood systems minimise the burden to both taxpayers and the exchequer of administration and compliance. A simple system is also fairer, in that it boosts accessibility. It also improves the integrity if the system by minimising the requirement for time and money to be spent on tax specialists to calculate or avoid tax burden."
2. Neutrality: "It is important to ensure that decisions regarding a taxation system are made on merit, rather than on the basis of tax consequences. Neutrality is important in minimising negative or unintended effects of taxation – such as on labour supply decisions and the allocation of resources. It does not however, necessarily imply that the tax system should not be utilised to influence behaviours, especially where welfare and efficiency can be improved via taxes."
3. Stability: "The stability and predictability of the tax system relates both to the stability of revenues, which governments raise through taxation, and the stability of tax rules, which face individuals and businesses. A key aim of any tax system should be to ensure that the revenue stream from taxation should be relatively predictable at least to the extent that it meets a minimum level, in order to facilitate forward planning. Stability of

tax rules and procedures allows for predictability and certainty in the decision making and planning of individuals and businesses."

4. Flexibility: "In light of evolving economic, social, and technological conditions, it is generally accepted that a tax system should be sufficiently flexible to be responsive to change – particularly in a dynamic and constantly evolving global economy. One particular area of focus is the tax principles and frameworks for the digital age. A well-designed tax system strikes an appropriate balance between flexibility and stability, enabling a government to respond to changes while still creating a system which allows predictability and certainty."

B10.8 These principles have been adoped by the Scottish Government and applied to the limited tax powers the government currently has. We recommend that these principles should underpin the transfer of taxation powers and the setting of future tax policy.

B11 MANAGING THE GOVERNMENT'S BALANCE SHEET

- Substantial value to governance and finances will flow from effective management of the public sector's portfolio of assets and liabilities; and its balance sheet. This does not mean the privatisation programmes such as those that the UK has pursued, but maximising value to the public purse of assets it holds.
- The IMF estimates developed world balance sheets are commonly c70% of GDP. The UK balance sheet is smaller and for many countries the assets outweigh the stock of public debt.
- Better allocation of capital should be a priority at all times. A good understanding of the balance sheet gives the most informative measure of financial sustainability.
- Examples are examined from small advanced economies to better allocate capital and assets and manage debt and risk.
- Scotland should quickly establish a best in class Debt Management and Assets Office, with consideration being given to allocating broad aggregate balance sheet responsibilities to this institution.
- A comprehensive and accurate inventory and valuation of assets and liabilities held by the Scottish Government and public sector should be undertaken and maintained.
- Opportunities for capital release into the Fund for Future Generations should be reviewed every 3 years.
- An on-going and robust system for asset management and reporting should be created.

B11.1 Much of the attention in government financial management relates to the nature of the aggregate fiscal path as well as the ability to exert fiscal control through a high quality budgetary process. But an additional area of substantial value to the government comes from the efficient, effective management of its portfolio of assets and liabilities (the 'government balance sheet'). On the asset side this includes financial and commercial assets, as well as physical assets such as buildings, infrastructure, and defence and national heritage assets.

B11.2 Across the developed world, the IMF estimates that the size of central government balance sheets is commonly above 70% of GDP (Figure 7-5). For example, the UK has non-financial asset holdings of around 50% of GDP, slightly below the advanced economy average, and financial asset holdings of an additional 30% of GDP. The New Zealand government reports total asset holdings of about 100% of GDP. For many countries, these holdings of assets outweigh the public debt stock.

B11.3 Better allocations of capital across priority areas can free up capital for new needs (including fiscal consolidation), and more efficient management of these assets and liabilities can make a substantial contribution to the fiscal position. A good understanding of the government

balance sheet also gives a superior measure of fiscal sustainability than simply referring to the fiscal balance or the debt level.

B11.4 Small countries, from New Zealand to Norway, have a record of institutional innovation in government assets and liability management. For example, New Zealand led the world in establishing a full government balance sheet in the early 1990s. And the IMF notes on-going progress in the preparation of comprehensive balance sheets across many advanced economies. There is much that Scotland can learn from the international experience in establishing world-leading public sector financial institutions.

B11.5 A traditional argument for preparing government balance sheets is to strengthen fiscal transparency. For example, a clear statement of government assets and liabilities reduces the risk of fiscal consolidation through accounting trickery – selling assets, avoiding recognising liabilities or investing using public private partnerships rather than government debt, and so on. These accounting devices can generate a meaningful fiscal impact. But increasingly the focus is on the extent to which stronger government balance sheet management can lead to improved fiscal decision-making and stronger fiscal outcomes.

Approaches to Government Balance Sheet Management

B11.6 The way in which these assets and liabilities are managed, and in which capital is allocated, makes a direct contribution to the quality of fiscal outcomes. Drawing from the international experience, particularly from small economies, this discussion considers two themes in government balance sheet management.

Effective Management of Government Assets

B11.7 The materiality of the government's asset portfolio means that improvements in the way in which these assets are managed are likely to have a significant impact on fiscal outcomes. For example, a 1% across-the-board productivity improvement in the government asset portfolio (of say 70% of GDP) would result in a fiscal saving of 0.7% of GDP. Of course, not all assets are subject to these types of productivity improvements, but the point is that small improvements on a large asset base can generate substantial fiscal benefits.

B11.8 Consideration of the international experience with respect to asset management suggests several classes of improvement that are relevant to Scotland.

B11.9 First, clearly allocating ownership to specific agencies can make a difference: as managers take greater responsibility for managing assets and allocating capital. This is less likely when asset ownership and decision-making rights are less clear. This was an immediate benefit in New Zealand when agency balance sheets were required to be prepared, with ownership rights vested in the agency. Agencies took their asset ownership role much more seriously.

B11.10 Second, financial incentives should be created to manage assets efficiently. A classic example of this is a capital charge, in which the Ministry of Finance charge the asset-owning agency an amount that reflects the cost of capital on the asset. The intuition is that the

agency should face the full cost of continuing to hold that asset (rather than seeing the cost of capital as free) to prompt consideration of whether asset ownership is required to deliver the outputs and outcomes they are meant to deliver.

B11.11 Many countries have some form of capital charge, such as New Zealand, Australia and the UK. There is an on-going debate about the effectiveness of these provisions, but some charging mechanism seems appropriate for consideration. Another way of approaching this issue, seen in countries such as Finland, is to charge rent to government agencies that are using government property. This creates a similar financial incentive system as the capital charge, but without the complexity.

B11.12 Third, encouraging efficiency through benchmarking exercises. For example, the UK's National Audit Office reports a recent benchmarking exercise through the High Performing Property Initiative. In this exercise, each property-owning agency reports on property costs and occupancy, which are then benchmarked against public and private sector peers. They report significant savings, from reducing office space required and increasing property utilisation (annual savings of over £1 billion).

B11.13 Similarly, New Zealand has recently benchmarked the use of real estate and office space across government agencies. This data was used to create baselines that provide formal guidance for agencies in terms of appropriate use of office space, and has reduced the amount of office space that is required. In many cases, surplus accommodation has been sold or re-purposed for other uses.

B11.14 Once comparative data has been obtained from the benchmarking exercise, work can be done to better understand the sources of the variation and to identify ways in which improvements can be made, with focus on locations where capital productivity is low.

B11.15 Fourth, is the need to build capability around asset management. Many advanced economies had developed decentralised public sector management systems, in which individual agencies were responsible for operations (including asset management). However, specific agencies may not have access to the capability to manage their assets well in instances where these require specialist skills. Over the past several years, there has been a tendency towards establishing more centralised asset management functions, particularly with respect to property management. Examples can be found in Australia, the UK, and New Zealand.

Debt and Risk Management

B11.16 In addition to managing the government's asset portfolio, it is also important to actively manage the government's debt portfolio, as well as the many types of risks (and contingent liabilities) that sit on the government balance sheet.

B11.17 Public debt management offices are a very well-developed institution and there is a keen sense of what good practice looks like in this regard. These offices raise and manage the government's debt portfolio, aiming to minimise the government's borrowing costs. In

some cases, these offices also have a mandate to contribute to the liquidity and maturity of debt markets in a country. These functions generally sit within the Finance Ministry, but operate independently (subject to risk and other guidelines). There are also examples of these debt management institutions being responsible for managing some types of assets (generally financial assets). They would also manage local government debt.

B11.18 In addition to the efficient management of these liabilities, the government needs to manage the significant fiscal risks that sit on government balance sheets. Some of these risks are straightforward financial risks (valuation risks, and so on). But there are frequently many other risks and contingent liabilities that need to be actively managed. A recent National Audit Office report on the UK Government's asset and liability portfolio documented the many risks and contingent liabilities that the UK was exposed to through its increasingly diverse asset holdings.

B11.19 A balance sheet perspective makes it more likely that there will be a structured approach to the management of these risks. In countries like New Zealand, the Treasury (including the Debt Management Office) has responsibility for this. But various other organisational forms, including dedicated asset owning agencies, are also observed (for example, UK Government Investments). An appropriate set of organisations and accountabilities should also be established in Scotland as the nature of its asset holdings becomes clearer.

Implications for Scotland

B11.20 The initial priority for Scotland is to quickly establish a 'best-in-class' debt management office to manage the debt stock, and to lead on raising further debt to fund the deficit. The ability to raise debt efficiently and quickly, and to manage this debt on the best possible terms, will make a significant contribution to manage Scotland's fiscal outcomes. There are many examples of high quality debt management institutions in small advanced economies, and Scotland should replicate these functions and shadow seconded staff from successful outside DMOs in the early phases. This is also a way of building on the financial sector strengths that Scotland already has.

B11.21 There is a good argument for this institution to have broader aggregate balance sheet responsibilities, particularly for the financial asset holdings. In that role, it would need to work in close cooperation with the asset management side of the Fund for Future Generations. It could also lead on any asset sales processes, project financing (an investment bank for the Scottish Government), as well as the management of financial assets as well as some contingent liabilities. This would be explicitly an Asset & Liability Management Office (as is the case now in New Zealand), or it could be a Debt Management Office, but with broader responsibilities.

B11.22 This agency would likely sit within the Ministry of Finance but would have a high degree of autonomy, independence, and its own credibility (similar to the UK DMO). Over time, this agency would become accountable for significant amounts of capital.

B11.23 The second priority is to develop a comprehensive inventory of assets and liabilities that the Scottish Government would hold. Scotland already has existing asset holdings, and there would be a further transfer of assets and liabilities from the UK to an independent Scotland as part of the negotiation. There should also be an agreed process for asset and liability valuation, and assigning specific ownership, accountability and decision-making rights with respect to those assets, so that agencies know what they are responsible for. This would be an on-going process, but it is an important element to get right early.

B11.24 Third, an initial review of the extent to which the assets on the government balance sheet should remain so should be undertaken: is there a clear public policy objective associated with on-going government ownership so that assets are stewarded effectively? Or can the capital can be recycled into higher value uses or released for debt reduction? This should be done in a structured way, to ensure high quality decisions are made for the long-term. But this may have the potential to make a meaningful contribution to the fiscal consolidation process at the same time. This would not drive government policy on the delivery of public services and would be an on-going process, with an initial review undertaken in the first 2-3 years.

B11.25 The final step, which will take some time to implement, is to establish a robust system for asset management and reporting. For example, creating financial incentives to impose on asset owners, building appropriate asset management capability, undertaking benchmarking exercises, and so on. There should be regular reporting and monitoring of this portfolio of assets and liabilities at both agency and whole-of-government levels.

Implementation

B11.26 The basic infrastructure around balance sheet management can be established. Agreement should be reached on the accounting standards that are to be used (e.g. guidance from New Zealand, the UK), as well as on how comprehensive these should be in the first instance. The inventory and valuation process should be commenced and ownership rights formalised Consideration should also be given to establishing a central asset management function for some assets (e.g. financial assets). A process for balance sheet reporting should also be developed.

B11.27 A review of government asset holdings to identify whether there are any material opportunities for capital release or for reallocation should be undertaken. But, for the most part, balance sheet management is an on-going task.

B12 DELIVERING A CREDIBLE & SUSTAINABLE FISCAL FRAMEWORK & POLICY

- Target a deficit value of below 3 per cent within 5 to 10 years.
- National debt should not increase beyond 50% of GDP and should stabilise at that level.
- Borrow only for public investment in net terms over the course of the cycle.
- During the transition period real increases in public spending should be limited to sufficiently less than GDP growth over the business cycle to reduce the deficit to below 3% within 5 to 10 years. At trend growth and target inflation rates this would mean average annual cash spending increases of above inflation in contrast to the Scottish budget experience under the UK regime of recent years and that scheduled for the remainder of the current planning period.
- The impact of fiscal management on growth must be tended to and it should be noted that this rule will apply over the business cycle. This means that in periods where growth is expected to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth.
- Governance recommendations from preceding chapters should be delivered swiftly and purposefully.
- Initial premiums on borrowing costs compared to the UK are not anticipated to be problematic but the target of policy should be to reduce the gap towards small advanced economy benchmarks. An assumption is made that *initial* debt interest costs could be 100bps above UK levels, the level estimated by the ratings agencies in 2014.
- 10 year debt accumulation is not anticipated to rise over 40% of GDP. Scotland's commitment through the Annual Solidarity Payment on UK debt servicing would affect deficit rather than debt.
- The analysis set out in this report shows that the target of a deficit value of below 3 per cent within 5 to 10 years can be achieved without any assumptions in increased growth. Achieving the growth aspirations set out in Part A would have the effect of bringing forward the timescales required to meet the fiscal target.
- A potential transitionary fiscal boost to growth should be considered and should be consulted on and considered depending on the prevailing economic circumstances and the perspectives and price required by debt providers.

Fiscal Rules

B12.1 In chapters B7 to B11 of the report we detail the analysis we have drawn upon from the record and performance of small advanced economies that have delivered successful and credible governance frameworks and policies.

B12.2 From this work, we conclude that the immediate fiscal policy priorities for Scotland will be to agree a binding framework to ensure:

- The deficit is reduced to below 3 per cent of GDP within 5 to 10 years;
- That national debt does not increase beyond 50% of GDP and stabilises. This will automatically constrain what fiscal deficits are allowed;
- Borrow for public investment only over the course of the cycle.

B12.3 In the early years, there will be a need to establish and maintain fiscal credibility whilst ensuring that the fiscal policy implemented supports rather than undermines the underlying growth performance of the economy.

B12.4 The UK's debt will remain the responsibility of the UK Government after Scotland becomes independent, as recognised by HM Treasury in its 2014 announcement. By definition, this means that an independent Scotland will start with zero debt. However, it is likely that an independent Scotland will agree to contribute to the debt servicing costs of a fair and reasonable share of UK debt (net of a share of assets). As set out in chapter 6, using 2021-22 as an illustrative starting point for an independent Scotland would be a deficit of 5.9% of GDP (excluding oil revenues), of which 1.6% of GDP will be the result of debt servicing payments to the UK Government (and this element will reduce over time, with inflation and growth, reducing the overall deficit).

B12.5 The commitment to servicing this debt means that Scotland's deficit will be higher than it otherwise would have been. Funding this deficit may require borrowing and lead to a build-up of Scottish debt.

B12.6 To achieve a public debt to GDP ratio of 50% or less within ten years, it will necessary for the average deficit to be below 5% and on a downward trajectory.

Governance

B12.7 The key priorities for governance include:

- Developing a fiscal institutions framework in legislative form: the fiscal policy guidelines/principles, the accountability, reporting and transparency requirements (e.g. that the government tables a fiscal strategy). The specific targets, the timelines, and so on, could follow once there is greater clarity on the starting point in terms of the fiscal deficit and public debt stock.

- Establishing an independent agency that would have responsibility for producing economic and fiscal forecasts, building on the Scottish Fiscal Commission's remit.
- Strengthening the annual budgetary process (in particular, strengthen the role of the Minister of Finance in terms of decisions on the fiscal envelope, specific allocation of resources).
- Implementing a structured spending review process of major spending categories (specify an approach and timeline to review major spending categories, agencies over the next several years). This is a 'no regrets' move and would generate benefits under the current arrangements.
- Establishing a DMO/ALMO with overall responsibility for managing the portfolio of government assets and liabilities.
- Commencing a review of government asset holdings to identify whether there are any material opportunities for capital release or for reallocation (e.g. of vacant buildings).

Delivering the Fiscal Targets

B12.8 The required journey to a fiscally sustainable position would be a necessary challenge for a newly independent Scotland, but the scale of what is required is well within what several other successful small advanced economies have achieved.

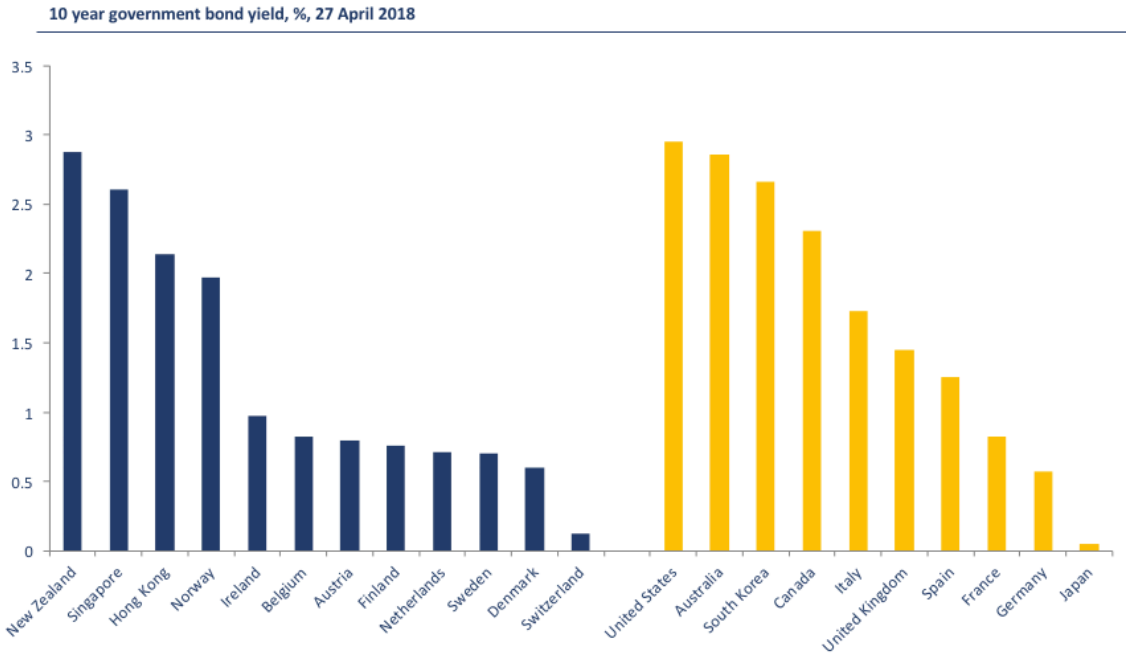
B12.9 The core lesson from other small advanced economies is that the most effective way to reduce the legacy deficit would be to control spending growth to no more than economic growth. It is important to strike a balance between fiscal credibility and reform with tending to the role of government spending in supporting growth, especially across a cycle and in support of longer term sustainable growth strategy.

Borrowing Costs

B12.10 The contribution made by Scotland to historic debt servicing costs, as part of the Annual Solidarity Payment, will be based on the existing interest rates on UK debt and so will be unaffected by the costs of UK or Scottish borrowing.

B12.11 However, during the deficit reduction period, an independent Scotland would require to borrow to fund the reducing deficit and so the borrowing costs that a newly independent Scotland would face become relevant. The 10-year bond yield for the UK is currently at 1.65% (Figure 12-1). In general, small economies have stronger credit ratings and low yields.

Figure 12-1 – 10 Year Bond Yields



Source: Macrobond

B12.12 Perhaps the best way is to look at the interest rate time series when small countries come under fiscal stress (NZ, Finland, etc.): it rose ~1%, before declining as things got under control. As a first approximation, the additional premium with independence as the country establishes credibility and a credit record could mean an extra ~100bp on rates relative to the UK – which would take Scotland to about 2.3%. Over time, this uncertainty would dissipate – and rates would reduce further. Other factors that make a difference include the liquidity of the bond market, the extent of portfolio inflows (whether institutional investors bring money into Scotland), as well as the risks associated with private debt. For the purposes of the analysis of the fiscal strategy set out below, the conservative assumption has been made of initial debt interest costs at 100 basis points above the current UK bond yield (based on the conclusions of the ratings agencies in 2014).

Set-up Costs and Invest to Save

B12.13 During the transition period, the government will require to invest in best-in-class new institutions for public administration and delivery of services, as it transitions from the Whitehall led delivery at present.

B12.14 This investment would cost resource up front but deliver exchequer savings in the longer term because administering from Scotland should be more efficient and lower cost than from London. Moreover, the money spent, in both capital and in salaries would see a greater proportion circulated in the Scottish economy and therefore flowing back in future revenues. There may be advantages of scale in UK government administration, but these are not obvious.

B12.15 We commissioned Professor Dunleavy of the London School of Economics to undertake an independent assessment of transition costs and assessed the period in which this will become exchequer positive. This research estimated the transition costs at £450 million over 5 years, and so an average of £90 million per year (0.05% of GDP). These costs would be recouped well within the first decade from the tax revenue associated with employees alone as well as providing further economic multiplier effects. Moreover, the intention to create best in class institutions will provide opportunities for savings in the longer term, in particular from efficiencies in the costs of governance.

Scotland's Fiscal Strategy

B12.16 For the initial consolidation period, we recommend modest real terms increases in public sector expenditure.

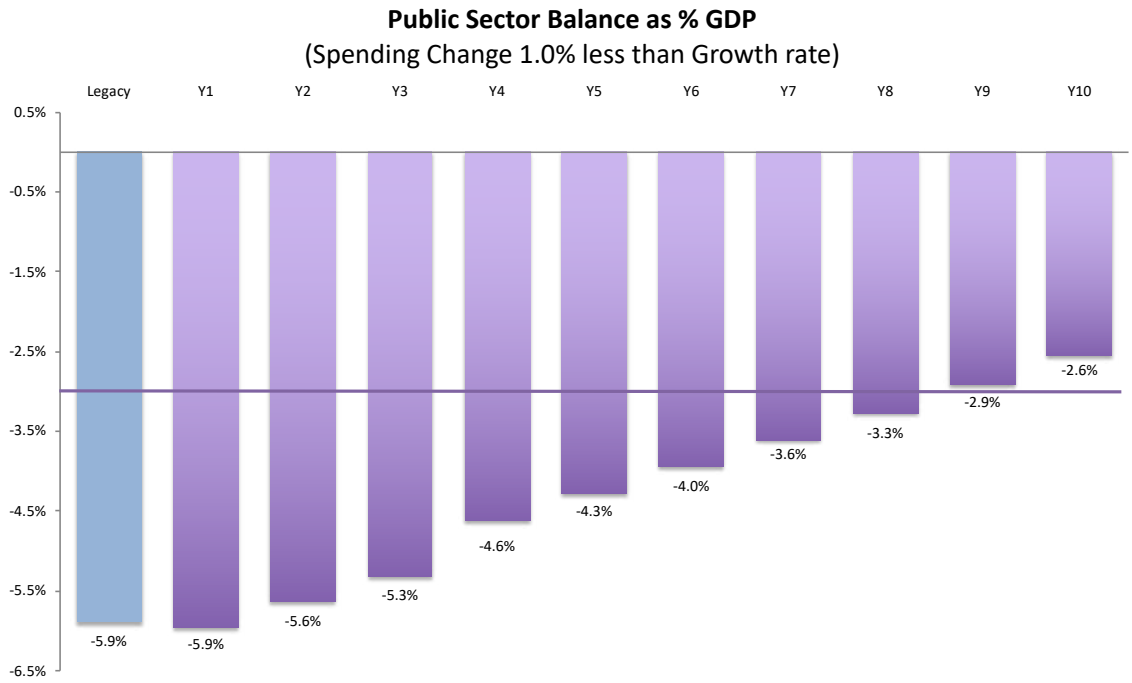
B12.17 The impact of fiscal management on growth must be addressed and it should be noted that this rule will apply over the business cycle. In periods where growth is expected (by a new independent institution tasked with providing forecasts) to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth back to or above the trend rate.

B12.18 At Scotland's long-term trend GDP growth rate of 1.5%, and inflation at 2%, this would mean that nominal increases in public spending of 2.5% would reduce the inherited deficit from 5.9% of GDP to less than 3.0% of GDP by year 9 (Figure 12-2). Over a ten-year period that would require borrowing that would build up to 36% of GDP, well within the 50% limit of the proposed fiscal framework.

B12.19 This analysis takes account of borrowing costs (assuming a risk premium of 100 bps) and savings of 0.3% GDP[35] associated with investment in best-in-class institutions realised over a three year period from year 5.

[35] This saving of 0.3% is a conservative target for savings from best in class institutions. Improvement to the tax system alone, matching the best performing small economies in terms of the costs of collection as set out in Chapter 12, would realise more than half of these targeted savings. If greater savings can be achieved, this would decrease the time taken to reduce the deficit.

Figure 12-2 – Growth & Deficit Reduction (Real Public Spending Change 1% less than Growth)



Source: Sustainable Growth Commission Analysis

B12.20 This rule would also have the same effect of reducing the deficit to less than 3% of GDP, at different levels of growth. So, if the trend growth rate of the Scottish economy was to increase, in line with the small advanced economy comparators, this would give the Scottish Government options to accelerate the reduction of the deficit, increase public spending, reduced taxation, or some combination of these.

B12.21 Other options such as reducing spending in some areas (for example, in defence), setting more ambitious targets for savings from investing in best-in-class institutions and increasing the tax base through population growth would also give the Scottish Government options to accelerate the reduction of the deficit.

Potential Fiscal Boost in Immediate Transition Period

B12.22 Establishing credibility within the first few years by following this fiscal strategy will be important. However, the analysis shows that the deficit can be reduced to sustainable levels within 5-10 years, whilst maintaining debt levels well within the 50% limit set out in the proposed fiscal rules.

B12.23 This could mean some scope for additional borrowing to fund investment for growth. Whether this would be the most appropriate economic and fiscal policy will depend on the economic environment at the time, which will be determined by a range of factors such as the time it takes the UK and Scottish economies to adjust to the shock of Brexit and the management of the economy by the UK Government over the next few years.

B12.24 There will be a trade-off. On the one hand, borrowing to invest in measures to boost growth could be interpreted by markets as a lack of commitment to fiscal consolidation and so undermine efforts to establish fiscal credibility despite extra revenues generated by that investment. On the other hand, a pause may provide some space and confidence to buffer this economic shock. Fiscal consolidation may be self-defeating if commenced too aggressively.

B12.25 Moreover, a comprehensive strategy to boost economic performance will also be a factor in establishing credibility and a fiscal boost focused on increasing the productive capacity and productivity of the economy could help to establish fiscal credibility, provided the strategy was clearly set out.

B12.26 To understand the nature of the trade-off, and the options available, it would be useful to commit to consulting with markets and business to understand the key costs and benefits with the initial phasing of the fiscal consolidation process. This consultation should take place during the negotiation period, after a referendum but before fiscal powers are transferred to the Scottish Government.

B12.27 It is also important that any initial 'fiscal boost' be designed for maximum economic benefit, and with the long-term in mind. It should be targeted at the key risks – such as lower business investment – and should be designed in a way that the measures can easily be reversed. This could include infrastructure investment and targeted tax relief (e.g. on business investment). To the maximum extent possible, it should also be consistent with the long-term economic strategy, rather than simply a short-term consumption boost.

B13 CONCLUSION

B13.1 This section of the report has demonstrated the fundability, viability and desirability of improving the fiscal framework, policy and approach to Scotland's public finances.

B13.2 By looking to the best examples from around the world we demonstrate the method by which Scotland can dramatically improve governance and outcomes and maintain debt at much lower levels than the UK has proven able to. We have also set out what we hope is a model of respect for the rest of UK and its interests and position. In particular we hope that the idea of an Annual Solidarity Payment will demonstrate the spirit of intent for both meeting shared obligations and ongoing collaboration.

B13.3 Wherever possible we have drawn on the latest official data for our presentation and from independent analyses that should make the core of the report beyond reasonable question. It is of course the case that the official numbers will change over time. That should not dramatically alter anything in this report other than the timing of when targets are reached.

B13.4 What we hope is now clear is that it is not a matter of whether Scotland *can* afford to manage its own finances but whether it *should*. It seems to us self-evident that continuing on the current UK model is unlikely to produce better outcomes than those seen at present.

B13.5 The counter factual is not clear from the current policy debate. How the UK proposes to achieve its fiscal targets and the implications for the UK regions and nations is, as yet, a moveable feast with each budget and statement. What is clear is a material, real terms reduction in the funding of the Scottish Government.

B13.6 We are of the core view that the performance of the economy needs carefully stewarded alongside the public finances. It is possible for Scotland to put its finances on a globally recognised credibly sustainable footing within five to ten years while maintaining inflation plus increases in public service funding as long as they lag trend growth. The greater the lag the faster the fix and we have set out options above for policymakers to consider. The target should be to achieve deficit targets within five to ten years.

B13.7 There is a lot in this report that should serve all sides in the political and policy debate. While we recognise that many do not yet support the case for independence we also hope that we have been able to demonstrate that it is, financially, a perfectly viable option. Indeed we go further and suggest that following the approach outlined in this report is an absolute imperative if improved economic performance is to become a reality.

B13.8 More than anything it is clear that the entrenched nature of the political debate in Scotland has seen too many capable minds closed to real possibilities. While we do not expect to persuade everyone, we do hope that we can engage in a manner that elevates the current debate.

B14 PART B: SUMMARY OF MAIN RECOMMENDATIONS

B14.1 As with Part A we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached and co-operation sought for policies that would benefit Scotland's performance long-term.

31. **Annual Solidarity Payment:** Following a successful independence vote an Annual Solidarity Payment should be created to allow the Scottish Government to pay an agreed share of the servicing of a net balance of UK debt and assets and any continued shared services payments.

32. **Comprehensive Review of Inherited UK Spending Programmes:** reporting within two years this would analyse the inherited strategy and choices for spending across the UK programmes excluding defence which would be subject to separate consideration. The purpose would be to identify savings from costs that need not be replicated, and tailoring to Scotland's specific position and needs. A saving of £1 billion should be targeted. As government functions are transitioned, further savings should be targeted by replacing the UK approach with institutions modelled on the best of the small advanced economies e.g. in tax collection. This element should target a saving of 0.3% of GDP by year 5.

33. **Standing Council on Scottish Public Sector Financial Performance:** this should be established to institutionalise the high performance and best practice (compared internationally) across the public sector; incentivising, celebrating and rewarding the best outcomes and efficiencies.

34. **Fund for Future Generations:** this fund should be created from all windfall revenues including any from north sea oil and gas. The focus of the fund would be on risk bearing by the public sector in exploiting inter-generational opportunities in the areas of Inclusive Growth, Innovation and Science, Infrastructure and the Green Economy. Further work is required on the detail of its remit and governance.

35. **Fiscal Targets: should be established and adhered to**:

i) Public debt should be maintained at no more than 50 per cent of GDP with borrowing only for public investment in net terms over the course of the cycle.

ii) Public sector deficit should be reduced to below 3 per cent of GDP and maintained at levels consistent with a 50 per cent debt threshold. Over time the definition of fiscal

balance should be extended to a broader balance sheet perspective to ensure no 'off-balance sheet' practice diminishes transparency.

36. **Scottish Fiscal Commission:** the resourcing and remit should be extended as policy competences are increased over time. Consideration should be given to its ability to measure the distributional impact of financial measures as well as the broader macro-economic and fiscal implications.

37. **Budgetary Process Review and Implementation:** the Finance Ministry should lead a budget process to ensure the fiscal transition is delivered effectively. The government's strategic priorities should determine negotiations with spending departments along with high quality spending proposals and a rigorous ongoing review of them. Such a review and implementation should borrow from the best international examples and be implemented as an immediate priority and dovetail with the Standing Council on Scottish Public Sector Financial Performance. The outcome should be a systemic process of structured spending reviews as in countries such as Denmark.

38. **Comprehensive Taxation Review:** is recommended drawing on the best expertise and experience globally with a view to recommending reforms to improve simplicity, neutrality and flexibility. This review should also target a reduction in the inherited UK 'Tax Gap', the difference between actual and anticipated revenues. Given the nature of such a review should be designed to outlast any one Parliamentary term it would be beneficial if a cross-partisan approach could be achieved.

39. **Debt Management Office:** This should be established to a 'best-in-class' standard to manage the debt stock and issuance of debt.

40. **Asset and Liability Management Office:** In due course the DMO should be extended to have broader aggregate balance sheet responsibilities for financial and other asset holdings.

41. **National Balance Sheet Review:** a comprehensive inventory of assets and liabilities held by the public sector should be undertaken and valued transparently. As well as allocating responsibilities to their management including an assessment of whether the public sector remains the best possible owner of them. Such a process would be ongoing but with an initial reporting period of two to three years. A robust system for asset management and reporting should be established.

42. **Deficit Reduction Policy:** this should be established with a target of delivering the initial deficit target of under 3 per cent of GDP within 5 to 10 years. Public spending increases in transition should be limited to sufficiently less than money GDP growth to deliver this.

At trend rates of growth and inflation this would allow annual average cash increases of above inflation.

43. **Transitionary Fiscal Stimulus** a fiscal stimulus to growth should be considered and consulted on depending on the prevailing economic circumstances and the perspectives and price required by debt providers. It should be designed to enhance the ability of the economy and public finances to deliver the medium-term target.

The **Sustainable Growth** Commission

Part C
The Monetary Policy and Financial Regulation Framework for an Independent Scotland

May 2018

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C1 CURRENCY RECOMMENDATION

- The Commission recommends that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period.
- A future Scottish Government should put in place the arrangements and financial infrastructure that would support a move to an independent Scottish currency at such time as this was considered appropriate for the Scottish economy.
- What happens with respect to currency the day before an independence vote would happen the day after and continue to happen until such time as the elected Scottish Government seeks to do something differently.
- The Commission recommends that a decision to move to an independent Scottish currency should be based on a governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is a necessity to maximise certainty and stability, and to minimise risks. We recognise that this means that the Scottish Government would not secure monetary policy sovereignty in the initial period following an independence vote though the Scottish Government would not be in a formal monetary union.
- This option allows the focus of the government, individuals, investors and businesses to be on policy choices for growth and the sustainability of public finances and the development of necessary institutions. It also removes a range of uncertainties concerning existing arrangements and contracts.
- We note with some interest that this was the approach taken by Ireland for an extended period, albeit in a different period of history.
- The existing financial assets and liabilities of Scottish residents, and the financial assets and liabilities which residents of countries outside Scotland hold with Scottish institutions, are assets and liabilities of these individuals, businesses and institutions, not assets or liabilities of the Scottish Government, before or after independence.

C1.1 Part of the Commission's brief was to take account of the recommendations of the 2013 Fiscal Commission reports, and the outcome of the EU referendum, and consider the most appropriate monetary policy arrangements to underpin a programme for sustainable growth in an independent Scotland.

C1.2 We have thoroughly reviewed the extensive work that was undertaken by the Fiscal Commission, as well as the headline recommendations that were made. Most of the detailed work that was undertaken, including the details of institutional design, remains valid and we see no need to repeat it – it will be available to those tasked with setting up the new institutions.

C1.3 This report therefore focuses on areas where the Commission believes that there is merit in taking a different approach, and on addressing questions that may be in the minds of businesses and individuals that wish to understand the implications of what is being recommended.

C1.4 The recommendation of the Fiscal Commission in 2013 was to continue the currency union with rest of the UK. The rationale was that sterling was the currency that fits the optimal currency area criteria best between Scotland and the rest of the UK. There was also an explicit recommendation to allow a change to a more flexible regime in due course, when economic conditions suggested that it would be in Scotland's interest to do so (Scotland's Future p111). However, during the 2014 independence referendum, the UK Government rejected the proposal for a formal currency union. While it remains a feasible outcome for both Scotland and the rest of the UK, it would create too much economic uncertainty for the formal currency union policy to be part of the proposition in a future referendum, since it is possible that a future UK Government could take a similar obstructive position. The blocking itself created unnecessary confusion and uncertainty for individuals, businesses and investors.

C1.5 The case for a sterling currency union remains strong since Scotland and the rest of the UK remain a close approximation to an optimal currency area and would continue to be so for some years after Scotland became independent. It would also provide continuity and stability. That said, critics argue that it would mean that Scotland's government would cede effective sovereignty over monetary policy while the rest of the UK would become exposed to the financial policy actions of the Scottish Government.

C1.6 It would be in the interests of both Scotland and the rest of the UK for existing and new institutions to work closely together during and after the transition to independence, and that is what we would expect to happen. However, unlike in 2014, the recommendations set out in this report do **not** require the pre-agreement of the UK Government or UK institutions.

Recommendation: The certainty and stability of 'Sterling Continuation'

C1.7 The Commission recommends that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period.

C1.8 In the longer term, if it were in the rounded economic interests of Scotland to develop its currency arrangements Scotland would, of course, be able to introduce its own currency. The Commission recommends that such a future decision should be based on a formal governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is an absolute necessity to maximise certainty and stability and to minimise risks.

C1.9 We recognise that this means that the Scottish Government would not secure monetary policy autonomy in the initial period following an independence vote. Our view is that the advantages of stability from retaining Sterling outweigh the benefits of introducing a new Scottish currency, at least in this initial period in the short to medium term.

C1.10 This option is not 'sterlingisation' (since Scotland already uses Sterling) and allows the focus of the government, individuals, investors and businesses to be on policy choices for growth and the sustainability of public finances. It also provides certainty and continuity concerning existing arrangements and contracts.

C1.11 We note with some interest that this was the approach taken by Ireland for an extended period, albeit in a different period of history.

Background: Role of Currency

C1.12 The functions of money are traditionally defined as those of medium of exchange, unit of account, and store of value. The medium of exchange describes the way in which people make everyday transactions. Traditionally they did so with coins but in the nineteenth century fiat money, paper issued (mostly) by state agencies, became dominant. The medium of exchange is a natural monopoly; there is a strong tendency for only one kind of paper or coin to be used for transactions in any one jurisdiction. It is, however, important to note that today cash is only used in a minority of transactions and accounts for only a small proportion of the total value of transactions. The natural monopoly of medium of exchange does not apply in the same way to electronic transactions as it does to cash transactions.

C1.13 The unit of account is the basis on which people make contracts with each other, keep accounting records, and plan budgets. Most businesses and some individuals employ several different units of account because they deal with many different customers and trade internationally. As a result, they deal in several currencies and if they prepare formal accounts they aggregate their different currencies for reporting purposes.

C1.14 Money also acts as a store of value. Businesses and households make deposits with banks and other financial institutions and invest for future needs and for retirement. This activity was once local - deposits were held in local banks and if investment was made in stocks or bonds such investments were generally in locally based corporations. But both banking and investment are now conducted globally. The majority of deposits and investments are private contracts and the underlying value of the investment depends on the terms of that private contract, not on any government decision.

C1.15 Unlike households, when states borrow on international markets they tend to borrow in widely used global currencies such as US dollars, euros, sterling or yen.

C1.16 'Legal tender' is now a concept of no practical significance - as demonstrated by the fact that the only 'legal tender' in Scotland today is coin. As a medium of exchange, people

use whatever medium of currency or currencies are generally accepted, which is why both Bank of England and Scottish bank notes are universally accepted in Scotland although neither are legal tender, and why Scottish bank notes are widely if not invariably accepted in England, though only Bank of England notes have legal tender status there.

C1.17 As a unit of account and store of value, businesses and individuals will use whatever is appropriate for their needs. Today we live in a global world, which allows considerable freedom for these businesses and households to determine what is appropriate to their own needs. Businesses which are outside the Eurozone or United States make contracts with each other in euros and dollars and choose to do so (or not) under English or US law and may use these currencies and legal systems for agreements that do not involve the US or UK in any way. Dollars, and to a lesser extent Euros, are widely used by individuals outside the United States and Europe and in many countries prices of large or tradable items are quoted in dollars even though payment will be made in local currency. Many businesses and individuals have bank accounts and other assets and liabilities in currencies which are not the currency of the country of which they are citizens or in which they are resident.

C1.18 Shares are quoted on stock exchanges in currencies which may or may not be the currency of the country in which that exchange is located and which may or may not be the currency of the country in which the company is registered. Other investments - unit and investment trusts, long term insurance contracts, pension funds - will generally be made in the securities of global companies which trade internationally and whose value depends on global economic developments, a value which will be translated into the local currency of choice at the time at which the holder wishes to sell the investment or draw his or her pension.

C1.19 Cash is of diminishing importance in everyday transactions. The value of physical sterling cash outstanding today is less than 5% of total UK Government debt. Cash balances have not generally been falling as a share of GDP, which seems puzzling given the shift to plastic and electronic transactions in everyday life. But there is growing evidence that much of the physical cash in circulation is associated with hoarding or illegal or semi-legal transactions. Cash circulating, or at least outside the banking system, in Scotland today is approx. £6-7 billion, more than £1000 per person living in Scotland, roughly equally divided between Scottish bank notes and Bank of England notes.

C1.20 There is no need for a formal monetary union between Scotland and the rest of the UK to enable Scottish businesses and residents to continue to use the pound sterling. In today's world, no one 'owns' a particular currency and the more widely acceptable the currency the less the issuer is able to restrict its use. What happens with respect to currency the day before an independence vote would happen the day after and continue to happen until such time as the elected Scottish Government seeks to do something differently.

C1.21 In a trading economy, the only restrictions an issuing authority can place on its own currency is to deny outsiders any influence over setting interest rates, or deny membership of its banking union, or supervision and regulation schemes or clearing system. Scotland, a small part of a global capital market, would have little influence on interest rates, even within Scotland, under any imaginable regime consistent with financial stability. An independent Scotland would operate its own banking regulation, in line with international norms and agreements, and (for Scottish retail banks) its own resolution scheme. To the extent necessary, an independent Scotland could operate its own payments clearing system.

C1.22 Governments which issue currency benefit from seignorage; notes are debt which is unlikely to be repaid (although holders can in effect insist on repayment by tendering the notes in payment of taxes or other obligations to the state). Initially Scotland could not enjoy such seignorage profits, although the amount at issue is small relative to the scale of government activity - as noted above, note issue is less than 5% of UK debt and at current interest rates the annual value of the perpetual interest free loan of £4 billion to the Bank of England, of which the current use of Bank of England notes in Scotland represents less than £100 million.

C1.23 The issue of notes by Scottish banks could continue on the present basis, under which they are backed pound for pound by Bank of England notes and deposits. For technical reasons, Scottish banks would thereby retain some seignorage benefits. At independence, the requirement to deposit Bank of England notes at the Bank of England would become a requirement to deposit Bank of England notes with the Scottish Central Bank. The notes would of course remain the property of the banks depositing them. The Scottish Government might in due course undertake issuance itself, initially with similar backing by Bank of England notes or deposits. As people became used to the arrangements and the security of the currency, such backing could probably be reduced.

C1.24 We expect that there to be a cordial and constructive relationship between the Scottish Central Bank and the Bank of England, and it would clearly be in the interests of both parties and both countries to establish and maintain such a relationship.

C1.25 As a result of the development of global capital markets and electronic transfer it is now virtually impracticable for an open economy to impose effective capital controls in the medium or long term. Scotland should not impose or attempt to impose restrictions on the movement of capital to or from Scotland.

C1.26 It cannot be emphasised too strongly that the existing financial assets and liabilities of Scottish residents, and the financial assets and liabilities which residents of countries outside Scotland hold with Scottish institutions, are assets and liabilities of these individuals, businesses and institutions, not assets or liabilities of the Scottish Government, before or after independence. There is thus no benefit, and a considerable downside, for a future Scottish Government to seek to legislate to change the terms of these private contracts. If

Scotland were to adopt a distinctive Scottish currency in future, that currency would be incorporated in future contracts - not in past or uncompleted ones.

C1.27 Any legislation a future Scottish Government might promote to alter existing contracts would be subject to the protections against expropriation of property in Article 1 of the European Convention on Human Rights (ECHR). The government of an independent Scotland would apply to become a member of the Council of Europe and it can be assumed that the application would be successful (the ECHR is governed by the Council of Europe, which has 47 members, including many countries outside the EU). The constitution of an independent Scotland should provide for protections of property rights at least as strong as those implied by the ECHR. Scotland would also be bound by its membership of other international institutions such as the IMF and whatever trading arrangements were negotiated with the rest of the UK, the EU, and other countries.

C2 TESTS FOR FUTURE CURRENCY OPTIONS

- The arrangements supporting the Scottish currency and the Scottish financial system should allow for the possibility that the Scottish Government may choose to establish a separate currency at some future date.
- In order to secure maximum long-term certainty, we recommend that the governance and rules by which any future choice could be taken are set in advance.
- The introduction of a separate Scottish currency, would be subject to six tests, an assessment of which would be made by the Scottish Government and put to the Scottish Parliament for approval:
  1. **Fiscal sustainability**: Has the Scottish Government sustainably secured its fiscal policy objectives and sufficiently strong and credible fiscal position, in relation to budget deficit and overall debt level?
  2. **Central Bank credibility and stability of debt issuance**: Has the Scottish Central Bank and Government framework established sufficient international and market credibility evidenced by the price and the stability of the price of its debt issuance?
  3. **Financial requirements of Scottish residents and businesses**: Would a separate currency meet the on-going needs of Scottish residents and businesses for stability and continuity of their financial arrangements and command wide support?
  4. **Sufficiency of foreign exchange and financial reserves:** Does Scotland have sufficient reserves to allow currency management?
  5. **Fit to trade and investment patterns:** Would the new arrangement better reflect Scotland's new and developing trading or investment patterns?
  6. **Correlation of economic and trade cycle:** Is the economic cycle in Scotland significantly out of phase with that of the rest of the UK, or at least as well correlated with the cycles of other trading and investment partners, thus making an independent monetary policy feasible and desirable?
- The conditions and rules that would determine a change of monetary policy and currency choice should, as articulated in this chapter, be made very clear in advance. In the event of a new Scottish currency being created it is likely that a period of 1:1 pegging with sterling would make sense for the short and possibly medium term.

C2.1 The continued use of sterling is the best method of achieving the critical objective of ensuring stability and continuity of financial affairs for Scottish businesses and Scottish residents, covering both trade and investment, in the initial period after independence.

C2.2 The arrangements supporting the Scottish currency and the Scottish financial system should enable the Scottish Government to choose to establish a separate currency at a future date. However, this should not be taken an indication of any commitment to do so.

C2.3 Even if there were to be such a currency change many individuals and businesses in Scotland would be free to continue to do business and transact many or most of their financial affairs in sterling and might choose to do so.

C2.4 However, in order to secure maximum long-term certainty, we recommend that the governance and rules by which any future choice could be taken are set in advance. This way the credibility and policy certainty required by individuals, companies and investors could be secured.

C2.5 The objective of monetary policy and strategy should be to:

- secure stable monetary unit with low inflation;
- secure an exchange rate regime appropriate to the needs of the Scottish economy;
- enhance the development of Scotland's economic and trading relationship with the rest of the UK, EU and international partners;
- minimise inconvenience, uncertainty and transactions costs for individuals and businesses.

The proposed Six Tests

C2.6 Any proposed change, and in particular the introduction of a separate Scottish currency, would have to be justified by its ability to meet these needs more effectively. The review would therefore focus on six tests:

1. **Fiscal sustainability**: Has the Scottish Government sustainably secured its fiscal policy objectives and sufficiently strong and credible fiscal position, in relation to budget deficit and overall debt level?
2. **Central Bank credibility and stability of debt issuance**: Has the Scottish Central Bank and Government framework established sufficient international and market credibility evidenced by the price and the stability of the price of its debt issuance?
3. **Financial requirements of Scottish residents and businesses**: Would a separate currency meet the on-going needs of Scottish residents and businesses for stability and continuity of their financial arrangements and command wide support?
4. **Sufficiency of foreign exchange and financial reserves:** Does Scotland have sufficient reserves to allow currency management?

5. **Fit to trade and investment patterns:** Would the new arrangement better reflect Scotland's new and developing trading or investment patterns?

6. **Correlation of economic and trade cycle:** Is the economic cycle in Scotland significantly out of phase with that of the rest of the UK, or at least as well correlated with the cycles of other trading and investment partners, thus making an independent monetary policy feasible and desirable?

C2.7 An assessment against these tests would be made by the Scottish Government and put to the Scottish Parliament for approval.

C2.8 Given the need for a transition period, the need to build institutional capacity and the timescales associated with establishing fiscal credibility (see the recommendations in Part B of this report), we anticipate that these six tests are unlikely to be met until towards the end of the first decade following a successful independence vote. However, it is possible that we have underestimated the economy's growth performance and potential and it will occur more quickly.

C3 SCOTTISH CENTRAL BANK & SCOTTISH FINANCIAL AUTHORITY

- The Commission recommends that two new institutions are set up, the Scottish Central Bank (SCB) and a Scottish Financial Authority (SFA), which would be a wholly owned independent subsidiary of the Scottish Central Bank.
- These new institutions should be created to provide the governance, necessary functions, structures and approaches of the existing UK institutions. The resourcing, scale and less complex nature of Scottish institutions would reflect the simpler structure and the different composition of the Scottish financial system.
- The Scottish Central Bank would assume final responsibility for the functions, in Scotland, of the FCA and the PRA in the UK through its SFA subsidiary (including both banking and insurance supervision).
- It would act as banker to the Scottish Government, and hold deposits and provide liquidity support, subject to the asset and collateral requirements, for Scottish retail banks, to the extent necessary to protect retail depositors. The SCB would operate a clearing system for these banks. It would also establish a Scottish Financial Services Compensation Scheme similar to the UK FSCS.
- As a result there is no reason why Scottish businesses and individuals should expect to borrow on terms in any way different from their rest of UK counterparts.
- Banks operating in Scotland with Scottish headquarters or through Scottish subsidiaries (and hence regulated by the SCB) would be required to ring-fence their retail banking operations along the same lines as now proposed for the UK. The SCB would put in place a resolution regime similar to that in the UK for the orderly winding down of failed banks. Financial support from the SCB would not extend to the holding companies of retail banks to cover activities outside Scotland, or beyond what is needed to ensure that retail depositors in Scottish banks are protected. It is anticipated that a number of banks may re-domicile their registered headquarters to London. A substantial part of the executive functions of these banks is already in London and so there would be a very limited impact on operational activity.
- The supervisory culture and institutional structures in Scotland will remain closely aligned with the arrangements for the rest of the UK and Scotland should aim to become a natural bridge between the rest of the UK and the EU.
- The SFA will focus on all other parts of the financial sector in Scotland.
- It is anticipated that it would operate a unitary regulatory model combining prudential and conduct regulation.
- The transition arrangement should seek to 'grandfather' as much as possible from the UK arrangements.

Principles of Scottish Financial Regulation

C3.1 The objectives of financial regulation in Scotland should be to:

- provide stability and continuity up to and after independence for Scottish providers and all users of financial services.
- protect Scottish consumers, savers and investors;
- promote Scottish financial services internationally;
- develop a financial sector that best serves the needs of the Scottish economy.

C3.2 To achieve these objectives, regulations should seek to repair the damage done to the financial sector's reputation for honesty and prudence in financial services by the failures that became evident in the UK banking system in 2008.

C3.3 These objectives can be met by pursuing equivalence - to licence companies to operate in Scotland provided their home country meets appropriate regulatory standards, and to expect other countries to offer similar freedom to Scottish companies operating in their jurisdictions. Equivalence has a specific technical meaning under current EU practice. The reference here is to the general principle rather than a particular rule. Debate over equivalence will be a key part of the Brexit negotiation.

Institutional Arrangements

C3.4 All financial systems require oversight by public authorities to set the rules for financial institutions and to ensure they are enforced. The functions that may be performed by the public authorities, in Scotland and elsewhere, include:

- regulate banks, primarily to ensure there are adequate capital and liquidity standards, drawing on international standards;
- authorise and supervise banks, to ensure they meet these regulations, have good governance and sound risk management, including for how they lend;
- oversee the payments system, to ensure it operates efficiently and serves the needs of the economy without disruption;
- act as a lender of last resort to individual banks that have a liquidity (rather than a solvency) problem, or provide emergency liquidity assistance to the banking system where there is a systemic need;
- provide deposit insurance, to ensure that retail customers of banks are protected if a bank gets into difficulty;

- resolution of banks that are insolvent, in a way that protects financial stability and the real economy, while minimising the exposure of taxpayers.

C3.5 In the UK, the Bank of England has the sole or primary responsibility for exercising these functions. In some cases, this is done through the Prudential Regulation Authority, a wholly owned subsidiary of the Bank of England, or in conjunction with other public-sector bodies, such as the Financial Services Compensation Scheme, which is responsible for administering deposit insurance. The Bank of England also operates in a wider global framework including the Bank for International Settlements rules for capital adequacy, transparency and risk management.

C3.6 The Commission recommends that two new institutions are set up, the Scottish Central Bank and a Scottish Financial Authority (which would be an independent wholly owned subsidiary of the Scottish Central Bank).

Transition and Implementation

C3.7 New Scottish institutions could be created to provide the governance, necessary functions, structures and approaches of the existing UK institutions. The resourcing, scale and less complex nature of Scottish institutions would reflect the simpler structure and the different composition of the Scottish financial system. In the case of banking, for example, when compared with London and the rest of the UK, there are fewer international banks and a higher proportion of banking activity is retail (providing banking services to individuals and businesses) rather than wholesale (providing services for other financial institutions).

C3.8 The priorities for action are described below.

- To establish, during the transition period before independence, a new institution which would at independence become the Scottish Central Bank and would assume final responsibility for the functions, in Scotland, carried out by the FCA and PRA in the UK (including banking and insurance/pension supervision). These functions are described more fully below. To maintain equivalence, the Scottish Central Bank would need to build expertise and establish close contact with regulators internationally, especially in London, Europe and the United States.

- To adopt, at independence-day, the existing FCA and PRA rule books (substantially implementing European regulation) in Scotland as the starting point of a Scottish regime of financial regulation, and to be developed in line with changing rest of UK and international requirements.

- In the early years of independence, the overriding need for stability and continuity means that equivalence would have the highest priority. As confidence in the capacity of the Scottish Government and the Scottish Central Bank grows, however, the Government and Bank will wish to review financial regulation in the light of the overall

needs of the finance sector and its customers and the requirements of the Scottish economy. Any such developments would follow extensive consultation and it is hoped that over time there would be opportunities for substantial simplification, while maintaining the fundamental objectives of equivalence and protection for Scottish consumers and the customers of Scottish businesses.

- To establish a Scottish Financial Services Compensation Scheme similar to the existing UK Financial Services Compensation Scheme - providing full coverage for insurance claims and coverage up to £85,000 for other financial services claims, including those of bank depositors. This should be a seamless transition from the UK to the Scottish scheme, so that there is no gap in coverage for depositors.

C3.9 The Scottish Government would also seek to negotiate a single arrangement for the joint regulation of occupational pensions with the rest of the UK, since so many schemes are UK wide. But, if such an agreement cannot be achieved, it will establish a Scottish pension regulator and pension protection scheme. In the interest of stability and continuity, a Scottish pension regulator would at independence adopt the rules and practices of The (UK) Pension Regulator and the current UK protection scheme but in view of the limited base to which a Scottish protection scheme would have access would consider finding some further mechanism of guarantee.

Functions of a Central Bank

C3.10 A stable financial system is an important part of overall macroeconomic stability and growth. Moreover, as became clear during the financial crisis, inadequate mechanisms to ensure financial stability can lead to banks that are "too big to fail" and to serious moral hazard issues that generate risky banking behaviour and sovereign risk that become correlated. Funding gaps between private savings and investment, between public spending and revenues, and between currency inflows and outflows, mean that loans and borrowing in one sector often drive loans/borrowing needs in another sector - making risk in the recipient sector extremely difficult to control. These risks need to be addressed and separated.

C3.11 A number of reforms have been made in advanced countries to reduce the risk of bank failures spilling over into the real economy, and to break the link between government and bank balance sheets. These measures include strengthening capital requirements, reforms to the structure of the banking sector, and new resolution tools.

C3.12 As part of these reforms, many central banks have acquired a stronger role in the oversight and delivery of financial stability. Most now have additional responsibilities for regulation and supervision, as well as tools to help deal safely with troubled or systemically important failing financial institutions. For example:

- Setting macro-prudential regulation standards (setting capital and liquidity ratios) to achieve and maintain financial stability;

- Regulating and supervising important financial institutions including the non-bank institutions;
- Preparing of resolution plans/strategies, including co-ordination across states for significant cross-border institutions;
- Providing extended liquidity facilities;
- Implementing resolution plans for troubled banks and other financial institutions including international agreement on how to ring fence ("re-domicile") domestic liabilities in multi-regional banks.

C3.13 However, there is no single institutional model to be copied here since some countries have regulation and resolution authorities separated from the Central Bank. For example, in the US, the Federal Deposit Insurance Corporation regulates the safety and soundness of banks, whilst twelve regional Federal Reserve Banks act as operating arms of the Federal Reserve System. In Ireland, the Irish Central Bank has a wider role as it is responsible for supervising the conduct of banks, in addition to monitoring their financial health. In the UK, the Bank of England's Prudential Regulation Authority performs that function through its Financial Conduct arm.

The Monetary Responsibilities of the Scottish Central Bank

C3.14 The Scottish Central Bank would act as banker to the Scottish Government, and hold deposits and provide liquidity support (subject to the asset and collateral requirements discussed below) for Scottish retail banks and operate a clearing system for these banks. This would replicate the existing structures for the UK (a real time gross settlement system alongside a net clearing system) but with advances in 'fintech' and the opportunity given by the establishment of a system from scratch it may be that there are more innovative options. In any event, all Scottish retail banks are currently, and are likely in future to be part of larger groups with access to the existing UK and EU clearing systems.

C3.15 Decisions as to the volume, timing and structure of Scottish Government debt would be made by the Scottish Treasury, but within the Debt & Asset Management Office (DAMO) (as proposed in Part B) which would oversee administration of issues and payments. The objective of the DAMO would be to ensure the efficient and low-cost provision of funds to the government, not to use government debt as an instrument of monetary policy. There could not be any separate Scottish analogue of 'quantitative easing', given Scotland's small size relative to the existing sterling paper market.

C3.16 The money market activities of both Scottish Treasury and Scottish Central Bank would need to be integrated with whatever arrangements were made following negotiations for any division of overall UK debt. Scotland's engagement with the pre-independence assets and liabilities in the Bank of England's asset purchase facility would be a matter for discussion in negotiations over the overall UK debt position. Such negotiations would

consider the balance sheet of the UK Government as a whole, not necessarily confined to financial assets and liabilities. In any event, the position of the UK Government as largest holder of UK Government debt is highly relevant to these discussions. Whatever the outcome of such negotiation, the legal liability for payment and the operational liability for servicing UK debt issued before independence will lie with the rest of the UK as successor state as detailed in our first report.

C3.17 By retaining Sterling we accept interest rates in Scotland would be set, as now, by the Bank of England. The Scottish Government would begin independent life with no, or virtually no, debt of its own. But we recommend in Part B that it should commit to servicing a share of historic UK debt. As we noted in Part B, it is likely that there would initially be some premium on Scottish Government debt over UK interest rates, reflecting the relative illiquidity of the initial market in Scottish debt and the unfamiliarity of markets with Scottish Government paper. But consultation with rating agencies suggests that this premium would be less than 1%. However, with prudent fiscal management this premium could be reduced or even reversed. Denmark and Switzerland have the lowest borrowing rates in the world, despite their small size relative to the Eurozone (Table 3-1).

Table 3-1 – Long Term Government Interest Rates

Long term rates (Government Bond Maturing in 10 Years)	2016 (%)
Denmark	0.321
Finland	0.365
France	0.468
Germany	0.090
Ireland	0.688
Norway	1.332
Sweden	0.519
UK	1.305
USA	1.842

Source: OECD (2018), Long-term interest rates (indicator), Average for 2016 (Accessed 28 January 2018)

C3.18 There is, however, no reason why Scottish businesses and home owners should need to borrow on terms in any way different from their rest of UK counterparts: loans to them will not carry any extra risk. It is possible, as has happened in other jurisdictions including the US, that first class private sector borrowers in Scotland could from time to time borrow at more favourable rates than their own government.

C3.19 In the period between a referendum vote and independence, the new organisation will need to build up appropriate expertise to enable it to exercise the functions of the Scottish Central Bank after independence. Much of this recruitment will need to be undertaken

internationally, but there will be many people with regulatory and Central Banking experience who will respond to the challenges and opportunities in establishing a new agency in a country with an especially strong heritage in financial services.

The Structure of Banking after Independence

C3.20 The significant banks operating in Scotland are banking groups whose main activities, assets and liabilities are located outside Scotland (with the possible exception of Clydesdale and Yorkshire Banking Group). It would not be right, or practical, for the Scottish-taxpayer to be asked to guarantee the overall liabilities of these banks.

C3.21 Current EU principles allow banks to trade in other member states through either branches or subsidiaries. Under EU passport rules, the primary responsibility for regulation of a business operating through branches lies with the home country (and in the event of failure claims must be made against the home country's deposit protection scheme) while subsidiaries are regulated by their host country and their depositors are protected by the host country.

C3.22 EU rules require that deposits of up to €100,000 are protected – the current UK figure is therefore £85,000. A cap is desirable to protect the scheme against fraud but at any time there is likely to be a small but significant number of households with very large balances for bona fide reasons, e.g. because they are buying or selling a house. Since 2015, there have been special provisions enabling the scheme to provide compensation up to £1 million in such cases.

C3.23 Thus, when the two principal Icelandic banks failed in 2008 (although Iceland is not an EU member the EU principles applied), Kaupthing was a subsidiary of the Icelandic parent and Landsbanki a branch. UK depositors of Kaupthing were automatically protected by the UK Financial Services Compensation scheme but Landsbanki depositors had to look to the Icelandic scheme, which failed (since all its contributing members were effectively bust). In practice, the UK Government, through the Bank of England, arranged that all UK depositors in both banks were paid out in full (i.e. the relevant liabilities of Landsbanki were covered, although there was no obligation on the UK Government to do so, and the cap on protected deposits was not applied to either Kaupthing or Landsbanki retail depositors) and the UK has attempted, controversially and with limited success, to recover some of the resulting losses from the Icelandic Government.

C3.24 The costs of compensation are in principle recoverable from all firms in the same sector, so that losses to depositors in insolvent banks are met by solvent banks. In practice, however, the UK FSCS met its obligations (and the additional ones imposed by the UK Government) through a loan facility from the Bank of England in excess of £20 billion. In the case of Northern Rock, the bank was nationalised and the state-owned entity met claims against it

in full; the FSCS was not involved. Such temporary state control may be the preferred route for a failed bank - see below.

C3.25 Banks operating in Scotland through Scottish subsidiaries (and hence primarily regulated by the Scottish Central Bank) would be required to ring-fence their retail banking operations, on the lines proposed for the UK by the Independent Commission on Banking and currently in process of implementation. After consultation, the Scottish Central Bank would introduce such rules on capital structure and asset quality on retail banks as are necessary to ensure that adequate collateral is available to match retail (i.e. household and small business) deposits in such banks. The objectives are to ensure that deposits are protected (if necessary by the provision of temporary liquidity against such collateral), and are protected in full (i.e. above as well as below the €100,000 limit), enabling the activities of failing banks to be continued or (more usually) transferred to another provider (if necessary with Scottish Central Bank or deposit guarantee), and to do so while involving minimal risk to the Scottish taxpayer or other Scottish banks. The Scottish Central Bank would be required to put in place a resolution regime similar to that which now exists for the UK to facilitate the orderly winding down of failed banks.

C3.26 Financial support from the Scottish Central Bank would be provided only to the ring-fenced retail entities operating in Scotland. If the requirements of ring-fencing are enforced and maintained, it is unlikely that these entities would encounter difficulties of either solvency or liquidity. If they did, and the parent were holding company were unwilling or unable to provide support. The SCB would provide such support as might be needed to ensure that cash would be available to meet the needs of retail and small business depositors.

C3.27 Given the requirement for ring fenced retail entities, the scale of the support that the SCB would provide would be manageable. The short-term support would be funded from the SCB balance sheet or, if the scale required it, from lending on commercial terms. The longer-term exposure of the SCB would be limited since the cash support provided to protect depositors would be offset by the value of the bank's ring-fenced assets. In practice, it is likely that the potential availability of such support would make its actual provision unnecessary.

C3.28 Such financial support would not extend to holding companies of retail banks (even if based in Scotland, and a-fortiori not to financial holding companies not based in Scotland.) It is likely that the result would be that some companies would move their domicile to England in response, in expectation of broader support from the Bank of England. This is in any event logical, since regardless of the location of the registered offices of RBS and Lloyds Banking Group, a substantial part of the executive functions of these banks is already exercised in London. Indeed most, if not all, of the banks have already made clear in public statements that they would be headquartered in London for the purposes of regulation in the event of independence. During the independence referendum in 2014 the charge was

made that an independent Scotland could not afford to "bail-out" banks deemed too big to fail. Given all of the above, this charge is no longer relevant.

C3.29 Two issues arise for Scotland from these anticipated re-domiciles. One is whether there would be a significant loss of operational activities in the banking sector. Public statements from the CEO of RBS Group for example suggest this will not be the case[1]. The other is the impact on tax revenues.

C3.30 Decisions by multinational corporations - including financial conglomerates - about where to locate operations are primarily determined by considerations of efficiency and cost rather than the location of their registered office. In 2015-6, total UK corporation tax revenue from the banking sector as a whole was £3.2 billion (about 7% of total UK corporation tax revenue). This figure includes revenue from foreign banks operating in the UK. This low figure is the result of historic losses (although action has been taken to limit this effect) and the complex corporate structures of UK financial institutions, which are substantially driven by tax considerations. In addition, the bank levy, an arbitrary tax on bank liabilities, raised £3.4 billion. While a Scottish Government could introduce a bank levy, an alternative possibility would be to ring-fence Scottish retail banking for corporation tax as well as regulatory purposes. We judge that it is probable that the revenue from this would exceed the £500-600 million (around 1% of prospective Scottish Government tax receipts) which would represent a pro rata share of total UK Government revenue from the banking sector.

C3.31 The policy approach of the Scottish Government should be to maximise continuity – of the rulebook and the approach to supervision – and hence to minimise uncertainty.

C3.32 There is a range of possible outcomes for the structure of the Scottish banking system that are likely to be satisfactory from a Scottish and the rest of the UK Government perspective, and from the perspective of the industry. We might naturally expect that some banks will modify their corporate structure to maximise their flexibility.

C3.33 In the longer-term there is a great opportunity for banking in Scotland. While the rulebook for banks in Scotland will be the European one – which may mean some divergence with the rulebook in the rest of the UK – the supervisory culture and institutional structures in Scotland will remain closely aligned with the arrangements in the rest of the UK. This means that Scotland will (and should seek to) become a natural bridge between the rest of the UK and the EU. The scale of the opportunity for financial services and jobs in Scotland is substantial.

[1] For example in a BBC interview on 16 August 2016

Scottish Financial Authority

C3.34 While the focus of political debate around the monetary framework for an independent Scotland has tended to be in the banking sector, the issues that arise are easily dealt with, as described above. Most of these relate to the operations of the Scottish Central Bank.

C3.35 The role of the Scottish Financial Authority will be to focus on other parts of the financial sector in Scotland, including those areas where Scotland has well-established, globally competitive expertise. This includes asset management in particular. The Scottish Financial Authority would be a separate institution to the Scottish Central Bank but it should be established as a wholly owned subsidiary.

C3.36 For any asset manager, it is a key requirement for long term success and viability that investors and clients have confidence in the level and quality of supervision and regulation. This prerequisite applies even more acutely for cross-border business and overseas clients and regulators will also expect appropriate levels of cooperation with the home country regulatory bodies and a credible body of law and regulation.

C3.37 In the context of an independent Scotland, it will therefore be important that all relevant stakeholders are given confidence in the newly established regulatory infrastructure. It would also be beneficial to have a sensibly planned transitional phase to ensure that there is no disruption to the delivery of services to investors and clients, and continued supervision of the activities of asset managers.

Policy Objectives

C3.38 A well-functioning savings market is important in three respects which should be reflected in policy:

- Scottish savers, individuals and institutions alike, will demand a system in which they can have full confidence. Regulation is a key element in building confidence. Credibility from day one will be essential because confidence is more easily lost than regained.
- Asset management, pensions and insurance are important parts of the Scottish economy, providing well-paid jobs and generating tax revenues. Most revenues earned by major firms are from investors and customers outside Scotland. Policy should aim to ensure that Scotland remains an attractive base for the underlying asset management activities. This requires credible regulation as an absolute prerequisite and policy should also aim to make the potential addressable market for Scottish managers as wide as possible. In this respect, the rest of the UK will be most important, and a regulatory regime maintaining reciprocal access should be a policy goal.
- It is important that Scotland has access to international capital. Government, businesses and households all depend on external capital to finance their activities. As a small,

open economy, it is in Scotland's interests to maintain credible regulation as a means of encouraging providers of capital to do business with us on favourable terms.

Overarching Principles

C3.39 The government, business and the public should have clarity on the objectives of the financial regulatory system. Using the International Organization of Securities Commission's (IOSCO) principles, these objectives could be described as:

- Protecting Investors;
- Ensuring fair, efficient and transparent markets; and
- Reducing systemic risk.

C3.40 As an example, the Central Bank of Ireland's mission statement is "Safeguarding Stability, Protecting Consumers". While the UK FCA has an overall objective of ensuring that relevant markets function well, supported by three operational objectives covering consumer protection, integrity of markets and promotion of effective competition.

C3.41 A close proxy for these principles would be a requirement for an independent Scottish financial regulator, even if organisational structures differed. The financial regulator should be operationally independent from Government but with appropriate political accountability for its actions and successful delivery of its objectives. It is particularly difficult to be specific about the future of regulation so long as the future relationship between the UK and EU (with or without Scotland) remains as vague as it does today. This uncertainty is particularly great in relation to financial services. Brexit will be damaging to the Scottish financial services industry and regulation will need to be crafted to minimise that damage.

Conduct and/or Prudential and Scope of Regulation

C3.42 An incoming independent Scottish administration would need to decide whether to operate a unitary regulatory model, such as pertains in Ireland, or whether to adopt a twin peaks model, splitting prudential and conduct regulation as is the case in the UK. The greater simplicity of the former approach would make it an attractive choice given Scotland's starting position.

C3.43 The FCA's and PRA's models and responsibilities are the obvious point of comparison for the new Scottish system. Differences are possible, of course, but should be clearly explained with assurance that quality of supervision has not diminished unduly.

Core Activities

C3.44 The new regulator would perform four core activities:

i. Policy making;

ii. Authorisation and supervision of firms and individuals;

iii. Enforcement;

iv. Internal operations.

C3.45 The first of these also requires specialist knowledge in the wider civil service. Ministers would need advice on the appropriate policy choices at a high level. Civil servants would need to be qualified in drafting suitable legislation to underpin the policies and rule books. Effective supervision also requires a considerable cohort of highly trained staff to oversee the complex operations of financial institutions.

C3.46 Similarly, enforcement requires a high degree of expertise and resource within the Scottish police and courts system to address complex financial crime such as money laundering.

C3.47 In addition, there would be a need to establish a relevant financial services compensation scheme providing a fund of last resort for consumers in the event that a financial services firm is unable to pay claims made against it. The UK FSCS is funded by the financial services industry and the levy is paid annually split across five categories: deposits, life and pensions, investments, general insurance, and home finance. With a smaller population of firms in Scotland and relatively few larger firms, the funding of such a scheme will need to be carefully managed so that it is not unduly burdensome on certain firms within the sector. Again, the current UK levy is an obvious point of comparison.

C3.48 A complaints and redress mechanism similar to the Financial Ombudsman Service - an independent body created under statute to provide an impartial complaint handling service for consumers – is also the international norm.

Practical Considerations

Resourcing

C3.49 The incoming administration will need to assess resourcing of the financial regulator prior to independence. Taking human resourcing first, looking at precedents, the Central Bank of Ireland stated in its 2015 annual report that it had around 1500 staff with a split of 300 in the central bank, 700 in regulation and 500 in operations. Taking a smaller operational example, Malta has 330 in its Central Bank and 280 in its financial regulator.

C3.50 Depending on the scope of activities and level of support from existing regulatory infrastructure in the UK, Scotland could be looking at a regulator potentially of 700 in number, of which at least 200 would need to be skilled and qualified professionals.

C3.51 In terms of operating costs, if we take the FCA as an example, its operating budget for 2016 was in the region of £520 million. This is funded by the fees levied on regulated firms, less any rebate for penalties retained from enforcement actions. Regulated firms in Scotland

will therefore be interested in understanding the impact and costs of supporting a new regulator in that jurisdiction, particularly given that many will choose to remain regulated by the FCA in the rest of the UK. Care should be taken to make Scotland cost-competitive in this regard.

Legislative Framework

C3.52 The practicalities of enacting a financial services legislative framework across all financial services activities will need to be considered. The care needed is heightened by the likely desire to retain equivalence with EU regulation in order to retain access to the EU single market in financial services. The complicating factor is that the apparent on-going debate within the UK Government on whether UK regulation should diverge from EU regulation following Brexit. It will be in the interest of the UK and Scottish financial services sectors to minimise divergence between UK and EU regulation. The rest of the UK market is important to most Scottish asset managers, consequently the objective of maximising access to both rest of UK and EU markets should be central to Scottish Government policy.

International Dimension

C3.53 The UK FCA has in place a series of memoranda of understanding with regulators globally which facilitates the exchange of information and cooperation of regulators regarding firms and activities which affect both countries. Scotland would need to ensure that similar arrangements are replicated for the Scottish regulator, and this will be important for the on-going facilitation of cross border business from Scotland. Likewise, it is important that an independent Scotland benefits from similar trade agreements and double tax treaties as are currently in force for the UK to support the sale of financial products and services from Scotland.

Systems and Processes

C3.54 Regulators are data driven. This requires a significant investment in technology to ensure that data from regulated firms can be received, stored and analysed. An appropriate transition from the UK FCA would also need to be coordinated to ensure a seamless transfer of records across regulators.

Transitioning to the New Regime

C3.55 Given the scale of the undertaking, as a general principle the policy should be to grandfather as much as possible from the rest of the UK arrangements, and inherit as much as possible too, including:

- Automatic authorisation of Scottish based firms: Asset management firms with a Scottish domicile or operations which are currently regulated by FCA should be grandfathered and automatically regulated by the Scottish regulator. There should be a simple transition process and no new or replacement application process. This

grandfathering process should cover both the firm and also all individuals (Senior Managers under the new FCA regime expected in 2018).

- Retain authorisation and regulation by the FCA: Given the scale of the activities performed in the rest of the UK by Scottish based asset managers, it would be helpful to ensure they can continue to be directly regulated by the FCA for the rest of the UK client base, so that there is no change to this regulatory relationship, as would happen if rest of UK operations were subsidiaries. In that way, authorisation by a Scottish based regulator becomes an additional regulator, rather than a replacement regulator. Any increased cost to doing business in Scotland would then be minimised in order to ensure the continuity of regulatory oversight. Over time, this position could be re-assessed.

- The arrangements between UK FCA and Scotland should aim for a reciprocal arrangement such that UK FCA regulated entities can delegate activities to their affiliated entities in Scotland. The benefit of this regulatory reciprocity to the Scottish economy is twofold. First it reduces the extent to which asset management activities may migrate to London in order to maintain a regulatory relationship with the FCA. Secondly, there is less disruption to the Scottish savings market, allowing the highly integrated UK market to remain in force, increasing consumer choice and encouraging competition.

- Inherit existing infrastructure: Where possible the Scottish regulator should use the existing systems and processes of the FCA so that there is as seamless as possible an interaction with the new Scottish regulator. This may also involve the secondment or use of FCA staff resources during the early stages of establishing a separate Scottish regulator or, more radically, agency work by the FCA for a period. The capacity of the FCA to accommodate this would of course be vital. The separation settlement could acknowledge historical Scottish investment in the UK regulator to help this happen.

- Adopt existing rules and legislation: so that there is no operational impact on day one, existing UK rules would need to be applied. In other words, UK legislation would be assumed into Scottish law and the FCA and PRA regulatory rule books adopted by the new Scottish regulator. On day one, given the EU Withdrawal Bill process, the rest of the UK, Scottish and EU regulation should be identical. However, there is the complication that over time, UK rules may start to diverge from EU standards and therefore Scotland needs to have capacity and capability to legislate over the medium term to adapt accordingly, to the interests of the Scottish financial services sector.

- Financial Services Compensation Scheme: a Scottish scheme similar to the existing UK scheme should be established, providing full coverage for insurance claims and coverage up to £85,000 for other financial services claims, including those of bank depositors, with a seamless transition so that there is no gap in coverage.

- Financial product regulation: this will be a particularly important area for firms where products domiciled in Scotland which are held by or sold to the rest of the UK customers become cross border products. Cross-border sale of products and services forms a significant share of most Scottish based firms' business. For some financial services providers, the potential uncertainty which this creates for investors and policyholders in these cross-border funds may create a commercial imperative to establish mirror products in the rest of the UK and transition the rest of the UK clients into these structures. It would be helpful if legal and tax mechanisms were developed and implemented prior to independence to facilitate the re-domiciling of such products in a cost-effective way for investors. This would allow firms to adapt their product line up to match their shareholder/investor base as appropriate. However, by providing clarity about currency and financial regulation, such uncertainty would be minimised.

C3.56 Returning to the position of Scottish-based managers and pre-existing funds registered in EU27 states, one of the essential requirements is that managers or funds in the EU27 jurisdictions are able to delegate portfolio management back to an asset manager based in Scotland. In any transition to an independent Scotland, an important task will be to ensure that Scotland is recognised as a third country to which portfolio management can be delegated. This relates directly to the perceived competence of the new Scottish regulator and the credibility of the regulatory framework.

C3.57 Should an independent Scotland meet these criteria, it could be an attractive venue for asset managers, including some not currently based here.

C4 KEY QUESTIONS & ANSWERS

Will there be a Formal Monetary Union?

C4.1 No, a formal monetary union will not be required. However, the Scottish Government expects that there will be a close and cooperative relationship between the new Scottish Central Bank and the Bank of England. The Scottish Central Bank and Scottish Financial Authority will assume in Scotland the regulatory functions presently exercised in the UK by the Bank of England's Prudential Regulation Authority and the Financial Conduct Authority.

What Notes and Coin will be used in an Independent Scotland?

C4.2 As now, currency in circulation in Scotland will continue to be a mixture of Bank of England notes and notes issued by Scottish banks. Scottish banks must currently support their note issue by making equivalent deposits with the Bank of England. On independence, this obligation will transfer from the Bank of England to the Scottish Central Bank. Otherwise, currency arrangements will continue as now. Depending on future arrangements with the rest of the UK, the Scottish Central Bank may choose to operate a payment and clearing system based in Scotland.

What will Happen to Bank Accounts after independence?

C4.3 Nothing. Bank accounts are private contracts, payable in sterling, between the account holder and the bank. Depending on the bank, this contract may be with an English or Scottish registered company and enforceable under either English or Scottish law. Neither the UK Government nor the Scottish Government is a party to that contract. Banking arrangements will be therefore be unchanged by independence and account holders will be able to make deposits, withdrawals and payments exactly as now.

Will it be possible to obtain Bank of England Notes from Banks in Scotland after Independence?

C4.4 Yes. At present bank branches will (if you have sufficient credit) give you Bank of England notes, or Scottish bank notes, or Euros, or US Dollars, or (with appropriate notice) any other currency you ask for. Mostly, this currency has been deposited with the bank by other customers but, if the bank does not have sufficient of the relevant currency, it will buy the required currency from another institution which does. This will continue to be the position after independence. In practice, all Scottish banks have substantial operations outside Scotland and already conduct operations in multiple currencies.

Will Bank Deposits be Safe?

C4.5 Yes. The Scottish Government will introduce a Scottish Financial Services Compensation Scheme which will provide deposit protection similar to that currently offered in the UK and all EU member states, as part of their respective banking unions. In addition, the Scottish Government will take over and reinforce the UK banking legislation which will become effective in 2019. This legislation requires banks to 'ring-fence' their retail operations, ensuring that these retail activities are separately capitalised, supported by a distinct pool of assets, and are operationally and in governance terms distinct from other activities of the holding company which owns the bank. Put simply, their purpose is to separate traditional banking from the wholesale and trading activities of the financial conglomerates which most 'banks' have become.

C4.6 The Scottish Central Bank will have a primary objective of restoring Scotland's reputation for prudent banking which services the needs of Scottish households, businesses and the Scottish economy, in a competitive market for banking services.

Who will be Lender of Last Resort?

C4.7 The significant banks operating in Scotland are banking groups whose main activities, assets and liabilities are located outside Scotland (with the possible exception of Clydesdale and Yorkshire Banking Group). If either the Scottish banking operation of a retail bank or the holding company which is the ultimate owner of a Scottish bank is unable to meet its obligations, the Scottish Central Bank will take over the ring-fenced retail operations of that institution in Scotland, but not for those parts outside.

C4.8 In such circumstances, normally the Central Bank will sell the assets and liabilities of the bank or the bank itself to other financial institutions (as the Federal Deposit Insurance Corporation does in the United States and as the UK Government did with the operations of Alliance and Leicester, Bradford and Bingley and Northern Rock). It may be necessary for the Scottish Central Bank, with the support of the Scottish Government, to provide temporary guarantees or liquidity support to facilitate such a transfer of activities. But with the introduction of ring-fencing and proper capitalisation and supervision of retail activities such support should not involve any significant cost to Scottish taxpayers.

C4.9 Neither the Scottish Government nor the Scottish Central Bank will bail out failed or failing financial institutions, although they will consider cooperating in international rescue or resolution operations in the interests of global financial stability. If this principle leads 'too big to fail' financial institutions to register their place of business outside Scotland, then Scottish taxpayers will be protected from the costs of such support operations and the consequences of irresponsible banking. Such re-domiciling of place of registration is unlikely to have any substantial effect on the operational locations of the banks in question.

The objective of the Scottish Government will be to restore Scotland's reputation for prudent banking and meeting the needs of the Scottish economy.

Will Unit Trusts (OEICs), Investment Trusts, or Other Shares be Affected by Independence?

C4.10 No. These investments entitle those that hold them to a share of the assets and earnings of companies, some of which are inside Scotland and some outside. Their value and denomination will not be affected in any way by Scottish independence. Shares and investment trusts are listed on the London Stock Exchange (or some other regulated market) and, if they are London listed, their prices are quoted in sterling. This will continue to be the case after independence (and would continue to be the case even if at some later date Scotland adopted another currency)

C4.11 The Scottish Government will, at independence, adopt in full the existing rulebook of the UK Financial Conduct Authority, including in particular its regulations regarding protection of client money, conduct of business, and 'treating customers fairly'. Savers and investors, whether they are Scottish residents or customers of Scottish businesses, will continue to enjoy exactly the same regulatory protections as now.

What will Happen to Insurance Policies?

C4.12 Nothing. As with bank accounts, insurance contracts are private contracts with the company concerned and are unaffected by the constitutional change. The Scottish Government will ensure that policyholder protection similar to that currently applicable in the UK will be available under the Scottish Financial Services Compensation Scheme. The Scottish Central Bank will implement a regulatory regime for insurance in Scotland equivalent to that operated by the Bank of England's Prudential Regulatory Authority.

What will Happen to Occupational Pensions?

C4.13 This is governed by the trust deed established by employers. Entitlement will therefore be unaffected by independence or where people choose to live. The Scottish Government intends to negotiate arrangements for the joint regulation of occupational pensions with the rest of the UK, since so many schemes are UK wide, but if necessary will establish a Scottish pension regulator and pension protection scheme.

Will an Independent Scotland Adopt the Euro?

C4.14 Scotland would retain sterling. If Scotland became an EU member in the future, it would be ready to accept that the euro is the official currency of the European Union, albeit that it is the actual currency of only 19 of the 27 member states. This acknowledgment does not

oblige Scotland to join the euro, either at independence or in the future. Denmark and Sweden are not members of the Eurozone and have no plans to join.

C4.15 Denmark obtained derogation at the time of the Maastricht Treaty and Sweden has stated that it does not intend to comply with the relevant criteria of that Treaty for membership of the Eurozone, a position which the EU has accepted. Scotland would join the euro only if and when such a decision is in the best interests of both Scotland and the EU, and the relevant criteria of the Maastricht Treaty were met.

Will there be Capital or Exchange Controls in an Independent Scotland?

C4.16 No. In today's world of electronic transfers and global capital and currency markets, it is very difficult to make effective controls on movement of capital or to stop residents from exchanging currencies. Such restrictions would be inconsistent with Scotland's future as a small open economy.

Will an Independent Scotland Adopt a Distinct Scottish Currency?

C4.17 Not in the short to medium term. The Scottish Government should commit to retaining sterling for an extended transition period. In due course, the Scottish Government should consider, on the advice of the Scottish Central Bank, whether this arrangement continues to be in the best interests of Scottish business and Scottish residents against a series of tests set out in advance of independence.

What Would Happen to Savings if Scotland did Adopt a Scottish Currency?

C4.18 Nothing. The majority of financial arrangements are private contracts between individuals, households and businesses, and financial institutions. These contracts are made in sterling and would continue to be in sterling unless the parties agreed to change their terms. For example, you could (but need not) agree with your bank to convert your mortgage or bank account from pounds sterling to any new Scottish currency. The Scottish Government could in principle pass legislation changing the terms of existing private contracts but has no intention of doing so and would gain no advantage by doing so: indeed, such legislation would be open to challenge under the European Convention on Human Rights and the provisions for the protection of property rights.

C4.19 If Scotland did at some time in the future adopt another currency, Scottish businesses and households would be free to conduct their business in sterling, the Scottish currency, or another currency – as they do now. It is likely that most businesses and many households would choose to maintain accounts in sterling as well as the Scottish currency. Euros circulate widely in both Denmark and Sweden and as more and more transactions become electronic this flexibility is likely to increase – and become less important. As many Scots travelling abroad will have experienced, national differences in currencies have much less

practical significance than they once did with the rise of plastic cards and electronic transfers.

Would Scotland need permission from the Bank of England to use Sterling?

C4.20 No. At the time of the 2014 referendum, the Scottish Government assumed more cooperation in financial and monetary arrangements than the UK Government was willing to extend. The Scottish Government's current plans therefore assume little or no cooperation. In practice, once the Scottish people had voted for independence, there would be a mutual interest between Scotland and the rest of the UK in securing a smooth transition. Regulators on both sides of the border and internationally could be expected to do everything in their power to promote stability and continuity[2].

[2] Such continuity plans were in place at the time of the 2014 Scottish independence referendum, as referenced in the Bank of England's Financial Policy Committee meeting minutes from 24th September 2014.

C5 PART C: SUMMARY OF MAIN RECOMMENDATIONS

C5.1 As with Parts A and B we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control.

44. **Currency Recommendation – Sterling Retention:** The Commission recommends that the currency of an independent Scotland should retain the pound sterling for an extended transition period.

45. **Currency future options: governance and tests:** In order to secure maximum long-term certainty, we recommend that the governance and rules should be set in advance. We recommend 6 tests detailed in the report for a future decision on currency to be based upon:

    i) Fiscal sustainability

    ii) Central bank credibility and stability of debt issuance

    iii) Financial requirements of Scottish residents and businesses

    iv) Sufficiency of foreign exchange and financial reserves

    v) Fit to trade and investment patters

    vi) Correlation of economic and trade cycle

46. **Scottish Central Bank: should be established.** This should be created to act as banker to the Scottish Government, holding deposits and providing liquidity support (subject to asset and collateral requirements) for Scottish retail banks and provide a clearing system for these banks. assuming the functions in Scotland of the FCA and PRA through its SFA subsidiary.

47. **Scottish Financial Authority:** as an independent wholly owned subsidiary of the Scottish Central Bank. Adopting the responsibilities of the UK FCA and PRA it would also take the lead on other (non-banking) parts of the financial sector in Scotland.

48. **Scottish Financial Services Compensation Scheme:** should be established by the SCB mirroring the UK FSCS scheme.

49. **Bank regulation:** banks regulated for their activities in Scotland by the SCB/SFA would be required to ring-fence their retail banking operations. A resolution regime would be established mirroring the UK approach for the orderly winding down of failed banks.

The transition arrangements would 'grandfather' as much as possible from the UK arrangements.

50. **Lender of Last Resort:** the SCB will act as lender of last resort to individual banks with a liquidity rather than solvency problem and provide emergency liquidity assistance to the banking system where there is a systemic need. After consultation, the SCB would introduce rules on capital structure and asset quality on retail banks to ensure that adequate collateral is available to match retail deposits in such banks. Financial support should only be provided to the ring-fenced retail entities operating in Scotland. It should not extend to the holding companies of retail banks whether operating in Scotland or elsewhere.