FI/S4/14/16/A

The Scottish Parliament
Pàrlamaid na h-Alba

FINANCE COMMITTEE

AGENDA

16th Meeting, 2014 (Session 4)

Wednesday 21 May 2014

The Committee will meet at 10.00 am in the Adam Smith Room (CR5).

1. **Scotland's Public Finances Post-2014** The Committee will take evidence from—

   Professor David Simpson, Economist and Author;

   Professor Jeremy Peat, Visiting Professor, International Public Policy Institute, University of Strathclyde.

James Johnston
Clerk to the Finance Committee
Room T3.60
The Scottish Parliament
Edinburgh
Tel: 0131 348 5215
Email: james.johnston@scottish.parliament.uk

FI/S4/14/16/A

The papers for this meeting are as follows—

Agenda item 1

Note by the Clerk	FI/S4/14/16/1

Finance Committee

16th Meeting, 2014 (Session 4), Wednesday 21 May 2014

Scotland’s public finances post-2014

Purpose

1. This paper provides copies of the written submissions that have been received from the witnesses who will be providing evidence at this meeting in relation to Scotland’s public finances post-2014. The submission from Professor David Simpson is attached as the annexe to this paper. The submission from Professor Jeremy Peat is to follow early next week.

2. The topics agreed by the Committee for these evidence sessions are—

- taxation
- borrowing
- public sector debt
- fiscal rules.

3. The Committee has also agreed to hold evidence sessions to specifically consider pensions and the Barnett formula.

Catherine Fergusson
Senior Assistant Clerk to the Committee

SUBMISSION FROM PROFESSOR DAVID SIMPSON

Independence and Government Debt

The UK Government will assume legal liability for the whole of UK Government Debt following Scottish independence. This paper explains why, in the author's opinion, it should also assume moral or political responsibility, and that consequently an independent Scottish Government need not accept liability for a population share of that debt.

1. The Size of UK Government Debt

The most commonly used measure of government debt in the UK is 'public sector net debt'. In 2014-15 public sector net debt is expected to be some £1,355 billion, equivalent to 77 per cent of GDP. In 2000 net debt was 31% of GDP, so the ratio will have more than doubled in fifteen years. The Office of Budget Responsibility (OBR) has forecast that net debt in cash terms will continue to rise at least until 2018-19, reaching £1,548 billion. This liability amounts to about £50,000 for every family in the country.[1]

At the present low rates of interest, the annual cost of servicing this debt exceeds £50 billion. This is the amount that the government has to find every year *just to pay the interest,* never mind the principal. It is more than the entire annual Defence budget. When interest rates return to a more normal level it is likely that the burden of servicing the debt will be impossible to sustain without additional increases in taxation and cuts in public expenditure beyond those already announced.

Even these very large numbers significantly understate the size of the UK's fiscal imbalance. The officially published measures of national debt, what might be called the explicit debt, are backward-looking measures. They do not reveal the extent to which the Government's unfunded future financial commitments, the implicit debt, cannot be met by future receipts on unchanged policies. No funds have been set aside to meet these future commitments, yet they represent government liabilities and therefore prospective indebtedness. They include promises to pay future pensions to public sector workers and future healthcare spending, as well as legacy PPI/PFI liabilities, Network Rail expenditures including HS2, ROC and new nuclear liabilities.

The Government does not produce forward-looking accounting measures that adequately reveal the size of this implicit debt, i.e. the unfunded portion of future spending commitments that are not financed by current tax plans, even although some of these commitments may actually be more predictable than the government's explicit debt. We are therefore generally in the dark about the true extent of total government indebtedness. The best available unofficial estimate puts the size of the implicit debt at over five times the size of the explicit debt[2]. Like an

[1] *OBR website March 2014*

[2] *J. Gokhale, The Government Debt Iceberg, IEA London 2014, Figure 12.*

iceberg, that part of the Government's indebtedness that is visible is only a fraction of the total.

Even if this estimate is only roughly accurate it underlines the urgency of creating an environment for sustained economic growth in order to generate the increasing tax revenues required to maintain our public services.

The size of UK government debt, explicit and implicit, seldom appears to be the subject of serious debate at Westminster. A run on sterling could be precipitated at any time. It might be triggered by financial markets' perception of a reluctance on the part of the British political class to face up to the difficult decisions that have to be taken, or it might follow another downturn in GDP, perhaps after the Westminster elections of 2015.

2. *How Did The UK Government Get Into This Situation*?

In the year 2000 UK net debt stood at 31% of GDP. Then, for the next seven years, despite strong economic growth, the public finances deteriorated significantly. In 2000 the UK ran an estimated 'structural' budget surplus, (i.e. a measure of the budget surplus adjusted for the business cycle), equivalent to 2.4% of GDP. But by 2007 that surplus had turned into a structural deficit of 5.2%. This was the result of unsustainable spending commitments entered into by the Government of the period, as well as persistently over-optimistic forecasts by the Treasury. In 2007 the UK had the largest structural budget deficit among the G7 economies. Across the 35 advanced economies monitored by the IMF, only Ireland and Greece are estimated to have had a larger structural deficit in that year.

Because of the Treasury's pipe-dream of '*no return to boom and bust',* its self-imposed fiscal rule of delivering a current account budget balanced over the cycle made no provision for the risk of recession, and was too slack by about 3% of GDP[3]. The UK was therefore poorly placed to deal with the fiscal consequences of the recession that began in 2008.

The Coalition Government has spent the four years since 2010 trying to put the public finances in order. There have been tax increases and cuts in planned spending. Despite these measures, the Government's debt has continued to grow. Mr Osborne is going to add an estimated £530 billion to the national debt in just five years. That's more than Messrs Brown and Darling added in eleven years. **In short, despite all the talk of 'austerity', the present government is going to double the national debt in cash terms in just one parliament.**

What are the reasons for this huge increase in debt? The politicians responsible are quick to shift the blame. They claim that in 2007 the British economy was hit by an "external shock", a "global financial crisis". In fact, the financial crisis that began in that year was neither external nor global. It was not global, because it was confined to Europe and the US. Not a single bank in Japan, China, Southeast Asia or even India failed or suffered a run in 2008. It was not external, because, unlike a meteorite strike, a financial crisis is a wholly man-made phenomenon. It was made by

[3] *M. Weale, National Institute Economic Review, April 2009, p.6.*

governments themselves, by their central bankers, Treasury officials and regulators in London and Washington, as well as by bankers on Wall Street and in the City. Bank of England officials, Treasury civil servants and their political masters all share responsibility for having led the British economy into the financial crisis of 2007/8 and then allowing it to languish in recession for four more years. Right up to the beginning of the crisis, the policymakers at the Treasury and the Bank of England refused to recognise there was a problem. The opening sentence of the Bank's *Financial Stability Report* in April 2007 read "The UK financial system remains highly resilient". Four months later, in August 2007, the run on Northern Rock began.

The fact is that British economic policies have aggravated rather than dampened the business cycle. In the years preceding the financial crisis, mortgage lenders were encouraged in the name of social inclusion to make loans to people who couldn't afford to pay them back. In the same period monetary policy was kept too loose for too long, stoking up bubbles in the price of houses and other assets. The mortgage market was barely regulated, while wholesale financial markets were not regulated at all. When the house-price bubble finally burst, bad property loans did even more damage to the UK banks than did trading in exotic derivatives. No legislative provision was made for dealing with insolvent banks. Successive governments led banks to believe, correctly as it turned out, that they were too big to be allowed to fail, thus underwriting their reckless behaviour.

No politician or civil servant in the Treasury or the Bank of England has accepted responsibility for these mistakes. Instead, it is ordinary people who have been punished. After allowing for inflation, average wages in Britain in 2012 were back to where they were ten years earlier. It will take until perhaps 2019 before they return to pre-recession levels. Under the 'protective umbrella' of the Union, average living standards in Scotland have fallen in each of the past five years. We have become poorer together.

3. Conclusion

If Scotland remains within the Union then its citizens will continue to be saddled with a burden of government debt for decades to come, a burden that will be difficult to shake off because of the existence of additional, implicit, fiscal liabilities. Its citizens bear no responsibility for the policy errors and unfulfillable political promises that have largely contributed to the present situation. The UK Government has already declared that it accepts legal liability for the whole of UK Government Debt following independence. It is my personal opinion that it should also accept moral or political responsibility, and that consequently a post–independence Scottish Government should not accept liability for a population share of that debt.

This opinion is fortified by a comparison of the contrasting experiences of Scotland and Norway. Despite oil tax revenues from the Scottish waters of the North Sea having contributed some £160 billion to the UK Exchequer since 1980, the imprudent policies of successive UK governments have meant that every family in Scotland has ended up with a debt of some £50,000. In Norway, on the other hand, the Government's management of that country's oil tax revenues has resulted in the accumulation of a national financial asset, a sovereign wealth fund that in 2012 was worth some £450 billion, or about £200,000 for each Norwegian family.

SUBMISSION FROM PROFESSOR JEREMY PEAT; UNIVERSITY OF STRATHCLYDE INTERNATIONAL PUBLIC POLICY INSTITUTE

Paper for Holyrood Finance Committee for Wednesday 21st May

Introduction

Having read the papers submitted for the previous two evidence sessions on this topic, and also the record of evidence, it is clear that a huge amount of material has already been submitted and much ground already covered. It is not my intention to duplicate or comment upon other submissions but rather to select some areas of relevance to the inquiry which I believe have not been fully debated and where there may be scope for some further value to be added.

The Currency Question

In considering possible policies post-independence the question of the currency to be used in such circumstances is of critical importance. In my view there are three questions to be posed regarding the preferred outcome:-

1. What currency would be preferable from the perspective of Scotland?
2. What currency would be preferable from the perspective of the remainder of the UK?
3. Which options are likely to be achievable and subject to what conditions?

The currency options may be summarised under four headings: -

1. A continuing currency union with rUK.
2. A Currency Board or informal use of sterling.
3. A new and separate currency – perhaps pegged to sterling or perhaps freely floating.
4. One of the above as a temporary measure en route to adopting the euro.

Given the close economic and business ties between Scotland and the rest of the UK, stability on the exchange rate would be much to be preferred, at least in the early years of independence. [That applies to Scotland and – to a lesser extent – rUK.] This stability would also, in my view, make it more likely that significant elements of the financial sector now present in Scotland remained here, to sell products across the nations of the UK and further afield. In addition, a perception in the markets that currency stability was assured for a number of years should also constrain the cost of borrowing for the Scottish Government and for those economic agents within Scotland.

I am not persuaded that a Currency Board or 'sterlingisation' – informal use of sterling – would be seen as securing that stability for any extended period. That leads me to prefer – at least for Scotland - the option of a continuing formal currency union; which obviously opens up the questions as to whether this is achievable and under what terms and conditions.

It seems likely to me that, at the least, negotiation of a continuing currency union would require a tight constraint on Scotland's fiscal policy, both in terms of limits on annual deficit and aggregate debt, but also some limitation of freedom to vary individual elements of tax policy, quite possibly including corporation tax.

It would also appear nigh on inevitable that monetary policy (interest rates et al) under this arrangement would be set primarily, perhaps exclusively, in the interests of the union's larger member – rUK. While there could be agreement for Scotland to have an observer on the Monetary Policy Committee, that person's influence would be marginal at best.

This would raise the question from the very outset as to whether the conditions under which a continuing currency union might be agreed permitted sufficient flexibility to Scotland on the fiscal and monetary fronts to develop her own priorities and policies. One observer has stated that 'the only terms under which a currency union would be feasible would be ones that no self-respecting nationalist could accept'. In other words there would be a cost-benefit trade-off to be assessed between the benefits of currency stability with rUK and the costs in terms of constraints on freedom of policy-making.

Even if it was deemed that severe constraints were acceptable initially, there could well be subsequent changes to the structure of the two currency union members such that this was no longer deemed to be the case. At that stage a move would appear necessary by Scotland to either enter the euro zone – assuming stability had returned there and this option appealed to Scotland – or establish a new and distinct Scottish currency, with all that that would entail. Any prospective move from the sterling currency union to euro or a separate currency would require sensitive handling to avoid adverse market reaction and flight of capital and businesses.

The Role of the Fiscal Policy Commission

While I am pleased that the new FPC is to be established, I believe that there are still issues to examine so far as its initial resourcing is concerned and also the status, resourcing and role of the FPC in the event of either further fiscal devolution or independence.

Clearly the role of the FPC in the context of the Scotland Act is limited. It will be examining the Scottish Government's estimates for revenue to be raised. But even in this limited context a few voluntary hours input seems small as does the sum available to buy in external input. Also, even at this early stage there might have been advantage in asking the FPC to comment transparently on overall Scottish Government fiscal projections; in liaison perhaps (while Scotland remains part of the UK) with the UK's Office for Budget Responsibility.

In the event of further fiscal devolution – which I am sure is both feasible and desirable if there is a 'no' vote in September – then the role of the FPC must be enhanced, both with regard to individual tax instruments and overall revenue and expenditure projections. This would require, in my view, some paid, albeit part-time, members and significant resources to buy in expertise, preferably from the Scottish academic community. This could include use of the model being developed as part of the ESRC's current programme. The FPC should be asked to comment fully, openly and critically on the revenue/expenditure projections and report to the Finance Committee. This committee, supported by the FPC, should then question the Scottish Government and seek changes or at the least full and persuasive responses to the FPC critique.

In the event of independence the Scottish Government should give serious consideration to setting up an even better resourced body, and also consider whether this body should, as with the OBR, generate the projections to be used in Government budgets. The sensitivity of overall revenue streams to the inherent uncertainty and potential variability of oil and gas taxation receipts adds to the complexity and risks that will be faced. How this difficult issue is dealt with will be of importance in achieving and sustaining confidence in the financial markets in the early years of independence.

Achieving Faster Growth

I was very interested in the debate at the last hearing as to how Scotland's growth rate might be improved. Attached at **Annex A** is a note which I submitted to the Economy, Energy and Tourism Committee in March which I hope may be of some interest. This specifically addresses some reasons why Scotland may have a problem with low productivity and hence a lower than desirable growth rate.

It can be argued that much would change in the event of independence – that those Keynesian 'animal spirits' would be much enlivened and enhanced entrepreneurialism would be unleashed to generate faster growth. This could be via harnessing the skills, funds and management expertise of the Scottish diaspora; and/or via encouraging skilled immigrants and making better use of the multitude of foreign students who come to Scotland and could be tempted to stay on and generate innovation; and/or via changing attitudes throughout the population encouraged by Government incentives and policies.

But whatever happens in the September referendum I am firmly of the view that we should be looking for a higher rate of investment and innovation, a more outward-looking and ambitious business sector and a much greater use for the benefit of all in Scotland of the massive amount of high quality R&D undertaken in our educational institutions. One part of this would involve looking at the availability of finance for investment and the role for banks; but the eye should also be focussed on our business sector, its management in particular, and on incentives across HE and business to enhance beneficial use of relevant and quality research in a number of key sectors.

May 2014.

ANNEX A

Some Thoughts for the Economy Committee; March 2014

Jeremy Peat
Director
David Hume Institute

Whilst discussion at the Committee may well focus primarily on issues related to the possibility of independence, I would wish to suggest that there are a number of other topics related to our economy which merit discussion in the context of ‘Scotland’s potential economic future’.

The key topic I would wish to have discussed is how Scotland’s productivity and hence potential growth rate could be increased. Low productivity across the UK since the last recession is a worrying fact. While the data are subject to varied interpretations, the position is certainly no better in Scotland than the UK norm and might be slightly less positive.

This trend in **productivity**, which leads to lower competitiveness against other economies, shows itself in low business investment and low innovation rates. The (welcome) higher than expected employment rates in recent years may well be associated with these trends regarding investment. In uncertain times businesses may prefer to increase employment rather than invest, as changing employment levels may be perceived as a more flexible albeit less productive approach.

Low **business investment** levels may be related to both demand and supply side factors. Businesses may decide of their own volition to invest less; or problems in access to appropriate finance may encourage them to defer investment decisions. Some of the evidence that I have seen in Scotland suggests that lack of demand may often be more importance than supply constraints, but nevertheless it is clearly important that the **financial sector** is open to requests for funds based upon sound investment proposals.

One continuing conundrum related to **innovation** is that whilst Scotland is a world leader in terms of HE R&D (HERD) activity our level of business investment in R&D (BIRD) and business innovation generally is low down the league table. We are rightly proud of the HERD achievement but why is this not translated into a strong performance on BIRD? (I accept some HE institutions work very hard at this.) Again there could be issues regarding the supply side – the incentive mechanisms for many of those involved in HERD may not lead them to seek BIRD opportunities as fervently and frequently as some might wish. Or (some – this is a generalisation for which I apologise) Scottish businesses could be reluctant to innovate as at times they appear reluctant to invest and grow beyond certain levels. Or it could primarily be a ‘matching’ issue. Those seeking to innovate do not know sufficient about the sources of HERD and hence innovation possibilities and vice versa. Or there could be funding issues, lack of access to the right type of risk capital.

Maintaining our emphasis on HERD whilst increasing the transition rate to BIRD could make a major contribution to innovation, competitiveness and potential growth.

Finally there is scope for more **exporting** companies in Scotland and for diversification of our export markets. The rest of the UK is clearly Scotland's major export market, followed by Europe and the USA. Major steps are being taken by SDI to encourage and facilitate access to emerging markets, but while a significant number of Scottish companies are achieving success in China, India, Brazil, etc. there is clearly scope for many more competitive exporting companies and increasing attention on these new markets. Exporters need to be competitive and exports stimulate growth.

The topics raised above are not independent but inter-related. I do not have the answers but wish the questions to be addressed – including the role of **management and ambition**.