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Foreword: Crawford Beveridge

I am delighted to present to Scottish Ministers the first report of the Fiscal Commission Working Group.

In the Autumn of 2014, Scotland will make the most significant decision on its future in over 300 years. Ultimately the choice will be a political one, but the economic implications and opportunities are central to the debate.

Given the importance of this momentous decision, it is essential that the people of Scotland have an opportunity to make an informed choice. It is disappointing that much of the economic debate so far has been negative and poorly informed. It is important for all sides to put forward a positive vision for Scotland – both under independence and within the Union.

To help shed light on the key economic issues of independence, I was delighted to accept the invitation from the First Minister of Scotland to chair the Fiscal Commission Working Group.

The Working Group was asked to “oversee the work of the Scottish Government on the design of a macroeconomic framework for an independent Scotland”.

It is not the job of the Working Group to determine what path Scotland takes. Instead the aim of the group is to use our expertise to provide advice and guidance to the government and to offer options for reform should a vote for independence be forthcoming.

Much of the report focuses on the complex and challenging design of macroeconomic policy. A macroeconomic framework, that is based upon fiscal discipline and financial stability, is an important pre-requisite for prosperity, fairness and economic opportunity and security.

Work to establish a robust macroeconomic framework is all the more important given the harsh experiences of the recent financial crisis. Advanced economies across the globe – including the UK – continue to deal with the consequences of an economic model that was unsustainable and a policy architecture that failed.

Our report contains a series of independent recommendations for Scottish Ministers to consider and are designed to enhance the debate on independence.
The proposition the Fiscal Commission Working Group has put forward is a workable blend of autonomy, cohesion and continuity. It is a well-engineered model designed for day one of independence.

The framework takes the status quo as a starting point and considers the challenges and opportunities that independence would bring. We believe – post independence – the broad principles and the proposed overarching framework will be in the interests of Scotland’s key partners and will provide a stable and attractive framework for both Scotland and the UK. The proposition is robust, flexible and considers both the UK and EU context. Understandably key elements of the framework will be subject to negotiation and agreement.

We encourage the Scottish Government, the UK Government and other interested parties, to engage on this proposition in advance of the referendum.

I am especially grateful to my fellow members of the Working Group – Professor Andrew Hughes-Hallett, Professor Frances Ruane, Professor Sir James Mirrlees and Professor Joseph Stiglitz – for the considerable effort and expertise that they have brought to this project.

Following publication of this report, the Fiscal Commission Working Group will continue its work in the coming months to help inform the debate.

Going forward we will be advising on how Scotland can learn from the best examples of other countries and the latest research in areas such as efficient tax collection, regulation and economic policy.

I hope that publication of this report can be the start of a positive and constructive dialogue on the economic future of Scotland.

Crawford Beveridge CBE
Chair, Council of Economic Advisers
February 2013
Fiscal Commission Working Group
Membership

Membership is drawn from the First Minister’s Council of Economic Advisers. The Chair is Crawford Beveridge CBE.

Crawford Beveridge CBE (Chair) – Crawford Beveridge is a technology industry veteran with more than 35 years of experience. This included working as an Executive at Sun Microsystems for over 15 years. In 1991, Beveridge left Sun to become Chief Executive of Scottish Enterprise. Beveridge returned to Sun in April 2000 as Executive Vice President of People and Places and Chief Human Resources Officer. In addition to being the Non-Executive Chairman of the Board of Autodesk, Beveridge is Chairman of Scottish Equity Partners Ltd, and a Non-executive board member of eSilicon and Iomart Group PLC. He was awarded a C.B.E. in the New Years Honours list in 1995.

Professor Andrew Hughes Hallett - Professor of Economics and Public Policy at George Mason University in the US, visiting Professor at Harvard University and Professor of Economics at the University of St Andrews. Professor Hughes Hallett specialises in international economic policy and has acted as a consultant to the World Bank, the IMF, the Federal Reserve Board, the UN, the OECD, the European Commission and central banks around the world.

Professor Sir James Mirrlees – Professor Emeritus at Cambridge University and distinguished professor-at-large at the Chinese University of Hong Kong. In 1996 Sir James was awarded the Nobel Prize for his work on economic models and equations about situations where information is asymmetrical or incomplete. In 2010, he led the Mirrlees Review of taxation which examined the principles and characteristics of a good tax system for open developed economies in the 21st century.

Professor Frances Ruane – Professor Ruane is Director of Ireland's Economic and Social Research Institute and Honorary Professor of Economics at Trinity College, Dublin. She has published widely in the area of international economics and industrial development.

Professor Joseph Stiglitz – Professor Stiglitz is Professor of Economics at Columbia University. He won the Nobel Prize in Economics in 2001 and was a member of the US Council of Economic Advisers (CEA) from 1993-95, serving as CEA Chair from 1995-97. He was Chief Economist and Senior Vice-President of the World Bank from 1997-2000. In 2009 he was appointed by the President of the UN General Assembly as Chair of the Commission of Experts on Reform of the International Financial and Monetary System.
Executive Summary

- By international standards Scotland is a wealthy and productive country.

- Even excluding North Sea oil output, GVA per head of population in Scotland is estimated to be 99% of the UK average and the highest in the UK outside London and the South East.

- However, over the last 30 years, Scotland’s economic growth rate has lagged behind that of many of its peers.

- Under the current macroeconomic framework, fiscal policy, monetary policy, financial regulation and key elements of industrial policy and economic regulation are reserved to the UK Government. The Scottish Government has no distinct input into these areas, and there is no form of accountability to the Scottish Parliament where the majority of spending allocations are made.

- Under independence, the Scottish Government would be responsible for the design and implementation of its own macroeconomic framework. There would be a number of choices open to Scotland as to how it could organise and manage its macroeconomy post-independence.

- The design of a macroeconomic framework typically revolves around three key pillars – monetary policy (including the choice of currency), financial stability and fiscal policy.

- A sound fiscal framework will be essential for a newly independent Scotland. This will be particularly true during the early years of independence, with clear benefits from demonstrating stability, competence and fiscal sustainability.

- Macroeconomic frameworks can – and should – evolve over time. At their heart however, should be a commitment to long-term stability, transparency and sustainability, whilst providing flexibility to respond to unforeseen events.

- The Working Group was asked to oversee the design of a macroeconomic framework and what is proposed in this report is designed to be robust, flexible and work from the first day of independence.

- Ultimately the exact framework will be subject to negotiation, and many of these discussions may not take place until after the referendum. However, the Working Group encourages all interested parties to engage on this proposition in advance of the referendum. The Working
Group is confident that the broad outline of this framework will be attractive to key partners including the UK and the EU if there is a vote for independence.

- In particular, the overarching framework would be in the economic interests – in terms of trade, competition and financial stability – of the UK post-independence.

- The propositions for monetary policy, financial stability, fiscal policy and their interactions offer fully engineered solutions to some of the challenges that have been highlighted with both monetary unions and macroeconomic frameworks more generally.

- It is designed to be flexible and evolve should the people of Scotland wish for further reform in the future and/or should economic conditions change. This is a key aspect of economic sovereignty.

- The framework proposed would represent a substantial step-change in the economic powers of the Scottish Parliament and greatly increase the economic and social policy levers at the disposal of policymakers in Scotland. Alongside this would flow new responsibilities and commitments.
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| **Principal Funding Source** | • Block Grant  
  • Size and pattern of funding determined by UK Government | • Full tax raising potential of Scotland |
| **Revenue Autonomy** | • Limited - 16% of tax revenues to be devolved by 2016  
  • Restricted to 2 Devolved taxes (landfill tax & stamp duty) and 2 local taxes (council tax and business rates)  
  • Sharing of income tax revenues, although most key decisions on rates, allowances and tax bands retained by UK Government | • Full Autonomy (rates, bands, allowances and administration)  
  • 100% of revenues responsibility of Scottish Parliament. |
| **Expenditure Autonomy** | • Current devolved responsibilities (Health, Education etc).  
  • Scottish Parliament responsible for allocating around 60% of public spending | • Full Autonomy to determine priorities  
  • Maximum opportunities to integrate and align key spending priorities with revenue autonomy  
  • 100% of expenditure (including welfare and defence) responsibility of Scottish Parliament |
| **Fiscal Responsibility (including debt management)** | • Fiscal envelope determined by UK Government  
  • Modest capital borrowing but no opportunity to stimulate economy during downturn  
  • Limited borrowing powers not available until April 2015 and future changes at discretion of HM Treasury | • Scottish Government fully responsible for fiscal sustainability  
  • Overarching joint ‘fiscal sustainability agreement’ to govern level of borrowing and debt within Sterling Zone  
  • Arrangements for financing existing UK debt agreed as part of post-referendum negotiations  
  • Independent Fiscal Commission to advise Scottish Government on sustainability of fiscal policy |
| Summary |
|-----------------|-----------------|
| **Economic Levers** | **Status Quo (incl. Scotland Act)** | **Macroeconomic Framework Proposal** |
| | • Responsible for many ‘supply-side’ drivers such as education and local economic development | • Full flexibility to manage fiscal and economic policy to support the Scottish economy. |
| | • Monetary policy and financial stability set for UK economy | • Monetary policy and financial stability set for Sterling Zone |
| | • Limited autonomy over taxation and other policy levers to improve competitiveness and social outcomes. | • Full autonomy over tax and other ‘competitive’ policy levers, target explicit challenges & opportunities facing Scotland |
| | • Rely upon UK Government for key decisions in reserved areas (‘one-size-fits-all’) | • Scottish Parliament fully responsible for economic growth, inequality and sustainability |
| **International Representation** | • No specific international representation | • Greater representation in Europe allowing Scottish circumstances to be reflected in the design, transposition and enforcement of economic policy and regulation |
| | • Limited scope to assert Scotland’s distinct position in international economic decision making arenas | • Opportunity to work in partnership with interested parties in areas of mutual benefit |
| | • Reliant upon UK and Scottish interests always being fully aligned | • Full membership and representation of international organisations |
| **Economic Sovereignty** | • Determined by UK Government | • Full economic sovereignty with Scottish Parliament |
| | • Future powers at discretion of UK Government | • Ability to evolve economic framework to future opportunities, pressures and demands of the people of Scotland |
1: Introduction and Background

Background

1.1 In 2009 the Council of Economic Advisers (CEA) recommended the establishment of an independent Fiscal Commission to help inform the future direction of fiscal policy in Scotland\(^1\).

1.2 Scottish Ministers accepted this recommendation, agreeing to the establishment of a Fiscal Commission to provide advice and guidance to help deliver a sustainable fiscal future alongside moves to greater autonomy.

Fiscal Commission Working Group

1.3 The Fiscal Commission Working Group was established on the 25th March 2012.

1.4 The Working Group was tasked with overseeing the detailed technical work being taken forward by the Scottish Government to design a robust macroeconomic framework for Scotland post-independence. A detailed log of engagement with the members of the Working Group and Minutes of meetings are available on the Scottish Government’s website\(^2\).

1.5 The Scottish Government is committed to holding a referendum on independence in 2014. As part of the process, the government will publish a White Paper in Autumn 2013.

1.6 To help support the development of the government’s thinking prior to the White Paper, the Working Group will publish recommendations and oversee a series of reports to help inform the debate. This report is the first in that series.

1.7 A set of initial recommendations are set out in Chapter 2. The development of this framework and report has been led by the Working Group with analytical input and

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1 Introduction and Background

support from key officials in the Scottish Government. The Working Group is committed to providing impartial advice on Scotland’s constitutional future.

Fiscal Commission Working Group Membership

1.8 The Working Group is a sub-group of the Council of Economic Advisers. It is chaired by Crawford Beveridge and its members are Professor Andrew Hughes Hallett, Professor Sir Jim Mirrlees, Professor Frances Ruane and Professor Joseph Stiglitz.

Remit of the Fiscal Commission Working Group

1.9 The remit of the Working Group is to:

• Oversee the work of Scottish Government officials on the design of a macroeconomic framework for an independent Scotland, including

  a) an assessment of the range of opportunities and risks from alternative frameworks over both the short and long-term; and,

  b) the development of a robust framework required to deliver a credible macroeconomic system that can operate from the first day of independence.

• Support the engagement with key institutions and external experts to help develop the Scottish Government’s proposals.

1.10 Since the establishment of the Working Group there has been a process of substantial engagement between members of the Working Group and the Scottish Government. The work of the group has also been informed by significant dialogue with key stakeholders, institutions and academics.

1.11 The Working Group met collectively in August 2012, November 2012, and February 2013. Given the international expertise of the group, much of the work has been undertaken via remote conferencing.
1.12 A full list of key engagement between Working Group and the Scottish Government is published on the Scottish Government website\(^3\) and will be updated accordingly.

1.13 This report is primarily focussed upon the mechanics – the ‘how’ – of independence and provides an initial set of recommendations on key areas of the macroeconomic framework. Future reports will focus on what could be achieved, relative to the status quo, from having greater control of fiscal and economic levers.

**Motivation**

1.14 The macroeconomic framework of a country relates to the structure and institutional design for monetary policy (including the choice of currency), fiscal policy (including government spending, taxation and borrowing) and financial stability (including monitoring of systemically important firms, resolution and deposit protection). All of these are linked and subject to interdependencies. Increasingly they are often developed in partnership with other countries.

1.15 A robust macroeconomic environment – characterised by low and stable inflation, currency stability, a strong balance of payments position, sound public finances and financial stability – is an essential ingredient in creating the right conditions for trade, commerce, job creation and efforts to tackle inequality. The experience of the last few years clearly highlights the costs of macroeconomic instability.

1.16 A sound macroeconomic framework is also a pre-requisite for effective economic policy in key areas, such as investment in education, skills, and infrastructure, which are in turn vital for economic growth.

1.17 Economies are however, subject to fluctuations leading to changes in incomes, employment and the distribution of wealth over time. Managing these fluctuations, both in terms of boosting resilience and flexibility is a key goal of macroeconomic policy.

1.18 All of these issues are discussed in this report.

\(^3\) http://www.scotland.gov.uk/Topics/Economy/Council-Economic-Advisers/FCWG
1 Introduction and Background

1.19 The timing of the constitutional debate, and the nature of relationships and partnerships in the modern global economy, mean that much of the detail of any framework will be subject to negotiation with these partners post the referendum. In that respect, it is important to acknowledge that political considerations will play a role and may cloud pre-referendum comments and policy statements. However, these are likely to differ from the actual decisions taken post-referendum when agreement is likely to take place where there are common interests.

1.20 The Working Group is of the clear opinion that such technical negotiations and discussions should take place in advance and that this would be in the interests of clarity and predictability for both the UK and Scotland.

1.21 The central objective has therefore been to design a workable proposition that delivers a robust and credible system that could operate from the first day of independence. It has drawn upon recent experiences across a range of countries and has been designed to be flexible to allow for variations in specific technicalities, such as institutional structures, following the outcome of any negotiations.

1.22 As with other successful macroeconomic frameworks, the system aims to be sufficiently flexible to evolve in the light of new economic developments and future preferences in the decades ahead. A key aspect of this is the gradual establishment of relevant macroeconomic institutions in Scotland.

Report Structure & Overview

1.23 The report sets out a series of recommendations and a framework reflecting the Working Group’s proposal.

1.24 Chapter 2 sets out the recommendations of the Working Group across a range of areas that will be key in shaping and developing a macroeconomic framework. Chapter 3 provides an introductory summary of the core proposition. The subsequent chapters provide further analytical background and detail in support of these proposals.

1.25 Chapter 4 provides an overview of the Scottish economy.
1.26 Chapter 5 sets out in greater detail the key characteristics and components of an optimal macroeconomic framework and its importance for economic growth.

1.27 Chapter 6 builds on the discussion in Chapter 5 by outlining the current constitutional arrangements, providing a useful context to the development of the proposals for independence.

1.28 Chapter 7 sets out the choices and the responsibilities open to Scotland post-independence in designing a framework for monetary and financial stability. Given the close linkages between these two elements of the framework they are discussed jointly. An accompanying technical 'currency options' paper is published alongside this report.

1.29 Chapter 8 sets out the key issues in establishing a robust fiscal framework for Scotland post-independence.

1.30 To bring all this together, Chapter 9 provides an overview of the proposed macroeconomic framework and the central proposition for Scottish Ministers to consider.

1.31 Chapter 10 concludes and provides an outline of future work to be taken forward by the Working Group in the months ahead.

1.32 Further reports will be published on the Scottish Government website⁴.

⁴ http://www.scotland.gov.uk/Topics/Economy/Council-Economic-Advisers/FCWG
1 Introduction and Background
2: Recommendations

2.1 The following set of recommendations outlined in this chapter reflect the emerging themes and areas of focus of the Fiscal Commission Working Group (‘Working Group’). This is the first in a series of recommendations which are designed to discharge the remit of the Working Group - set out in Chapter 1 - and to assist the Scottish Government in shaping and designing a robust macroeconomic framework for Scotland post-independence.

2.2 Ultimately the choice of economic framework to be adopted lies with the Scottish Government, and would be subject to the negotiations that would follow a yes vote in the referendum.

2.3 The recommendations are grouped under five key themes:

1) Macroeconomic framework:

2.4 The Working Group commends to the Scottish Government retaining Sterling as part of a formal monetary union, and believes that this provides a strong overarching framework for Scotland post-independence.

2.5 The Working Group also believes that – post independence – a shared currency would be in the interests of the UK given the trade and financial links with Scotland.

2.6 The Working Group also recognises that macroeconomic frameworks evolve over time as economic and political circumstances develop.

2.7 Recommendation: the Scottish Government should refine the detail of the proposition set out for a macroeconomic framework which can operate from day one of independence and through any period of transition and indefinitely if required. The framework should ensure monetary and price stability, financial stability and fiscal sustainability.

2.8 Recommendation: the Scottish framework should be sufficiently flexible to retain the capacity to evolve the framework in the medium or long term if economic circumstances warrant it.
2) **Fiscal framework:**

2.9 The Scottish Government should look to establish a fiscal framework – including the use of fiscal rules and an independent fiscal commission – which maximises economic policy flexibility and provides opportunities to promote economic growth, deliver greater economic resilience and address inequalities in Scotland.

2.10 **Recommendation:** the framework should focus on long-term sustainability through effective management of the public finances alongside ensuring growth, economic policy flexibility and creating opportunities.

2.11 **Recommendation:** the Scottish Government should seek, in principle, to establish a stabilisation fund such as an Oil Fund, to help manage its natural resources and to enhance future economic resilience.

3) **Financial stability:**

2.12 The Working Group stresses the importance of delivering a stable financial framework, both as part of the evolving UK and EU financial services market, given the need to ensure a properly regulated and functioning financial system at the heart of a successful economy.

2.13 The Working Group recognises the benefits from maintaining an integrated financial services sector that creates opportunities to address key internationally shared challenges, strengths and opportunities, subject to the need to ensure stability of the system and resilience of the Scottish economy. In principle, this should be based upon a foundation of effective supervision, resolution and deposit protection mechanisms.

2.14 **Recommendation:** the framework for financial stability should look to support economic growth across the whole of the Scottish economy and, given the presence of major cross-border institutions in the UK and the EU, seek effective coordination of financial oversight and supervision. As part of this, the government of an independent Scotland should use its international representation to press for strict and effective guidelines at the international level.
2.15 Recommendation: there should be a clear framework and structure to separate the link between the balance sheet of financial institutions and government and ensure the presence of clear mechanisms for crisis management and resolution.

4) Economic levers:

2.16 Independence would provide a substantial step change in the economic and social policy levers open to future Scottish Governments. A clear, evidence based and robust debate should take place to discuss how best to meet key priorities.

2.17 Recommendation: the Scottish Government should take forward a programme of work to identify and develop key economic and fiscal policy opportunities and choices within the proposed framework to deliver economic growth, resilience, fairness, opportunity and sustainability.

2.18 Recommendation: as part of this work, lessons should be drawn from the successful use and application of economic levers from other economies of comparable size.

2.19 Recommendation: in particular, in addition to boosting economic growth, the Government should explore and prioritise opportunities to address inequalities and to promote inter-generational equity and environmental sustainability.

2.20 Recommendation: the Scottish Government should take forward a programme of work to scope out and design an efficient and cost effective tax system.

5) Institutional structures:

2.21 Countries of Scotland’s size are not simply scaled down versions of larger economies. Instead they develop their own unique structures and institutions. Establishing these institutions and ensuring that the relevant skills and expertise are developed will be a key initial task for an independent Scotland.

2.22 Recommendation: institutions, skills and capacity should be developed to support the Scottish Government through the process of negotiation, transition and achieving full independence.
2 Recommendations

2.23 **Recommendation**: as part of their work on institutional structures the Scottish Government should:

- Consult key stakeholders about the detail of the proposals in advance of the publication of the White Paper.
- Develop a detailed transition plan.
- Explore options for establishing relevant institutions (e.g. debt management, fiscal, monetary and regulatory) and building the necessary in-house capacity and expertise to support macroeconomic policy development in the Scottish Government.
- Ensure that the design of any new institutions is efficient, flexible and credible.
- Establish a permanent independent ‘Fiscal Commission’ and a ‘Scottish Monetary Institute’ whose role and remit would be set by the Scottish Government. However they could act independently to advise stakeholders, including the Scottish Government, on the Scottish economy, public finances and international developments. Such institutions would play a key role as part of the evolution of the macroeconomic framework.
- Work with partner institutions to improve the coverage of economic data for Scotland and develop in-house macroeconomic technical expertise within the Scottish Government.

**Conclusion**

2.24 Meeting these recommendations would lead to the establishment of an effective macroeconomic framework for Scotland post-independence. The outline of the model set out in Chapter 3, and more fully in Chapter 9, provides Scottish Ministers with an initial framework that provides a strong basis for future discussion and refinement in the months ahead.
3: Summary: Macroeconomic Framework

Chapter Summary

- This chapter provides a short summary of the emerging macroeconomic framework.
- It covers monetary policy, financial stability and fiscal policy.
- A more detailed discussion of the framework is provided in Chapter 9.

Introduction

3.1 By international standards Scotland is a wealthy and productive country. There is no doubt that Scotland has the potential to be a successful independent nation.

3.2 Even excluding North Sea oil output, GVA per head of population in Scotland is estimated to be 99% of the UK average and the highest of any part of the UK outside London and the South East. When the value of North Sea output is added the size of the Scottish economy increases by around 20%.

3.3 Scotland has key strengths, particularly in sectors such as food and drink, life sciences, digital industries and tourism. Scotland also has a global reputation for science, engineering and creativity. And despite the recent challenges, the financial sector in Scotland continues to perform well, particularly in areas such as asset management and insurance. Scotland also continues to remain an extremely attractive location for international investment.

3.4 In energy, Scotland is one of the richest nations in Europe. It is estimated that there could be up to 24 billion barrels of oil and gas remaining in the North Sea with the vast majority located within Scottish waters. At the same time, it is estimated that Scotland has around 25% of all of Europe’s potential offshore wind and tidal energy, a tenth of Europe’s wave.

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power potential, and an estimated 50% of Europe’s potential offshore storage capacity which provides opportunity in carbon capture and storage.

3.5 The Scottish economy also faces challenges. Many of these have persisted over decades. Scotland’s long-term historical growth rate has lagged behind that of many of its peers. Between 1977 and 2007, Scotland’s average annual growth was 2.3% compared to 2.8% for EU countries of a comparable size.

3.6 As a country rich in natural resource and skills, there is no obvious underlying characteristic of the Scottish economy that can explain this underperformance.

3.7 Scotland’s business start-up and entrepreneurship rates have been lower than both the UK average and key international competitors. The country’s universities rank as some of the world’s elite, but in other areas of innovation such as business expenditure on research and development, Scotland has lagged behind key competitors.

3.8 Many of the key economic policy levers which could be used to tackle these challenges are controlled by the UK Government. Under the current arrangements for example, the Scottish Government/Scottish Parliament is directly responsible for 7% of its own revenues – a figure that will rise to 16% under the Scotland Act 2012. Other areas of policy such as economic regulation, international transport connectivity, employment policy and international representation are also largely reserved to the UK Government.

3.9 The issue is not that Scotland is necessarily burdened with poor policies but that the centralisation of economic policy levers means that specific policies – particularly in key areas – cannot be tailored to the specific structure, opportunities and challenges of the Scottish economy.

3.10 Scotland is also currently part of a UK economic model and society which is one of the most unequal in the OECD. Inequality within the UK has increased in recent decades. Such patterns of inequality will continue to have a negative impact on growth and prosperity over the long-term.

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6 Based on data compiled from The Scottish Government, ONS and OECD
3.11 Under the current constitutional arrangements, however, this is an area of responsibility where the opportunities for the Scottish Parliament and Government to adopt a different approach are particularly limited.

2014 Referendum

3.12 The Scottish Government is committed to holding a referendum on independence in 2014. To support this, the Government will publish a White Paper on independence in the Autumn of 2013.

3.13 Scottish Ministers believe that independence is the key to unlocking Scotland’s economic potential and the means to securing a fairer society.

3.14 In order for this to be achieved, a robust macroeconomic framework will be essential.

3.15 Failure to ensure macroeconomic stability risks undermining efforts to boost growth, improve employment prospects and tackle inequalities. Recent events – and particularly the inherent weaknesses in the model developed in the late 1990s and early 2000s – have highlighted the harsh reality of any failure to establish a robust and sustainable framework.

3.16 The Working Group believes that it is desirable – and in the interests of both Scotland and the UK – for both governments to enter into effective and meaningful dialogue on the proposition outlined below at the earliest opportunity.

Macroeconomic Framework

Principles

3.17 In 2009, in ‘Fiscal Autonomy for Scotland: the case for change and options for reform’, the Scottish Government set out two clear overarching objectives which it believed should underpin the design of a macroeconomic framework:

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3 Summary Macroeconomic Framework

- **long-term competitiveness** – maximising opportunities to raise productivity, competitiveness, economic security and resilience over the long term; and

- **short-run responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

3.18 To deliver on these objectives, the work of the Fiscal Commission Working Group has been focussed around four key themes:

- **Credibility** – the framework should deliver confidence for businesses, investors, financial markets and the people of Scotland. The design of a robust and transparent framework is essential to enable policy makers to take advantage of the discretion and autonomy that independence would bring.

- **Sustainability** – the framework should be affordable and support sustainable development – in the widest possible sense – over the medium to long-term.

- **Stability** – the framework should provide coherent and predictable macroeconomic policies. It should also retain sufficient flexibility to respond to short-term pressures and unforeseen events.

- **Autonomy** – the framework should seek to provide the maximum degree of policy autonomy. It should also be sufficiently dynamic to evolve over time to meet changing economic conditions or preferences.

3.19 The proposed framework takes as its starting point the status quo\(^8\) and aims to be a workable model for day 1 of independence. The framework will be subject to negotiation with the UK, although the overall structure of the proposition is believed to be of benefit to both governments post-independence.

3.20 The proposal is designed to provide the flexibility to evolve over time in response to changing circumstances or requirements. Central to this is the establishment of a number of key institutions to build capacity and knowledge in Scotland to inform the future direction of economic policy and reform.

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\(^8\) Including the financial provisions that are set out in the Scotland Act 2012
3.21 A central underpinning is the commitment by the Scottish Government to remain an active and positive participant in the European Union (EU). The government has made clear that it expects that Scotland’s transition to independent membership of the EU will be negotiated from a position within the EU.

3.22 The outcome of these negotiations will have implications for the final specification of the framework. However the overall proposal is designed to be sufficiently flexible to meet the likely and realistic requirements of membership of the EU. The starting point therefore is the existing and expected future requirements for membership placed on the UK.

3.23 The framework has been designed with the overriding objective of delivering macroeconomic, financial and fiscal sustainability. This is entirely consistent with the key economic principles and objectives of the EU.

3.24 Discussion of the framework is centred upon three key pillars:

- **Monetary Policy** – including the choice of currency and the framework for setting interest rates and the money supply to promote (‘price’) stability and minimise short-term volatility;

- **Financial Stability** – including the use of prudential regulation, supervision and resolution tools to ensure stability in the financial system; and,

- **Fiscal Policy** – including the setting of taxes, government spending and borrowing within an overarching framework of fiscal sustainability.

**Monetary Policy**

3.25 The choice of currency is a key determinant of the overall macroeconomic framework.

3.26 Analysis shows that it would be in Scotland’s interests to retain Sterling immediately post-independence. It is also the case that – post independence – this would benefit the rest of the UK given the scale of integrated markets, including in areas such as financial services.

3.27 Scotland’s economy is strong enough and sufficiently aligned with the rest of the UK that a separate currency would not be necessary. Retaining a common currency would promote
3 Summary Macroeconomic Framework

the single market and help facilitate trade and investment to and from the rest of the UK and elsewhere.

3.28 There would be a number of ways to implement monetary policy within a formal monetary union, including options around the institutional arrangements for central banking.

3.29 The preferred model would be for Scotland to enter a formal monetary union with the rest of the UK with the Bank of England (the Bank) operating as central bank for the common monetary area (the ‘Sterling Zone’).

3.30 Ownership and governance of the Bank could be undertaken on an agreed shared basis, reflecting Scotland’s current implicit and historical share of the existing Bank’s assets as a UK institution. This arrangement would be subject to negotiation with the UK Government. However a practical arrangement with shareholder rights allocated on a per capita or GDP weighted basis would seem appropriate.

3.31 Monetary policy would be set in the Sterling Zone according to economic conditions in both Scotland and the UK – in the same way as is currently the case.

3.32 The Bank would remain operationally independent to set monetary policy.

3.33 This would involve little change in the day-to-day operations of the Bank or in its discharge of monetary policy. The common payments and settlements system would continue, as would the efficient use of inter-bank money markets as the principal means of providing liquidity. The Bank’s balance sheet could remain unified, albeit indemnified by two fiscal authorities.

3.34 As part of this arrangement, the framework proposes that the Scottish Government should seek input into the appointment process to key positions within the Bank (for example the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC)) and an input into its remit and objectives. A representative from the Scottish Treasury could also attend MPC meetings in a capacity similar to the existing HM Treasury representative (i.e. in a non-voting capacity and to ensure that monetary policymakers were fully informed of developments in Scottish Government economic and fiscal policy).
Related to this, and as an explicit shareholder of the Bank, the Scottish Government and Scottish Parliament should seek a role in providing oversight of the Bank and its activities.

This would create an appropriate system of accountability and representation for both governments.

Matters of collective decision making on governance and accountability could be addressed within an overarching agreement on the functioning of the Sterling Zone. A shared institutional arrangement, such as a ‘Macroeconomic Governance Committee’, could be established to oversee matters which require coordinated input and/or agreement from the respective governments. This practical arrangement could cover not just monetary policy, but also issues of shared interest in fiscal sustainability and financial stability. Such an arrangement would also provide a forum for knowledge transfer and the sharing of key information.

**Financial Stability**

The crisis of 2007/08 has highlighted, perhaps more clearly than ever before, the importance of financial stability and the potential damaging effects on the real economy of financial crises. There are three key aspects related to this – effective supervision, resolution and deposit protection.

The failure of regulatory authorities and governments – particularly in countries with globally significant financial institutions such as the UK – to fully appreciate or identify the emerging risks in the financial sector directly led to the sharpest economic slowdown since the 1930s.

In response, policy makers across the world are actively reappraising the frameworks and institutions needed to monitor financial stability and reduce the probability and scale of future crises. A particular challenge for all countries in the increasingly interconnected global economy is the existence of large multinational financial companies with complex cross-border structures.

This is an area of on-going reform. For example, the UK Financial Services Act 2012 will overhaul the system of financial regulation in the UK. As part of this, the Bank of England is also being given a stronger role in financial stability. In Europe, the first stages of a ‘Banking
3 Summary Macroeconomic Framework

Union’ are being implemented which include a single cross-national supervisory mechanism and forthcoming proposals for more robust frameworks for resolution and deposit protection.

3.42 It is therefore essential that any proposed macroeconomic framework for Scotland takes these reforms into consideration and is sufficiently flexible to be able to respond to these on-going developments.

3.43 There are a number of major financial institutions which are incorporated in Scotland – but with significant headquarter functions elsewhere in the UK – that are integral to the overall stability of the UK financial system. Similarly there are a number of major London based financial companies with substantial systemic presence in Scotland. The framework takes this into account and the consequent merits for financial stability – in both countries – of a coordinated approach.

3.44 The proposition has been developed around aspects of financial stability from a macroeconomic perspective:

- **Supervision and Oversight** – a framework to proactively pre-empt instability in financial institutions, the sector as a whole, or instability in the wider economy caused by the actions of the financial sector;

- **Crisis Management, Resolution and Deposit Protection** – a framework for quick and efficient solution to crises that ensures confidence in the financial system.

**Supervision and Oversight**

3.45 As background, it is important to note that aspects of financial regulation are driven by internationally set rules and standards. As part of this context, in order to meet financial supervisory and regulatory roles, EU Member States are required to designate one or more independent competent authorities to oversee financial regulation. There are a number of institutional structures and arrangements that Scotland could adopt to achieve this.
Given the close linkages between macroeconomic stability and financial stability, the core proposition is for key elements of prudential regulation (both micro and macro\(^9\)) to be discharged on a consistent basis across the Sterling Zone.

This would also ensure that systemically important institutions which currently operate across the Sterling Zone were supervised on a common and consistent basis. This could be discharged either by the Bank on behalf of the Scottish Government or by a Scottish Monetary Institute (see Chapter 9) working in partnership with the Bank.

Macroprudential regulation would also be aligned in its new role to provide a valuable additional tool for promoting macroeconomic stability alongside monetary policy. In time – and as the use of macroprudential levers are refined – options to undertake spatial variation of such policy could offer a new mechanism to further boost stability and help to address any variations within the monetary union.

Other areas of financial regulation (i.e. elements which are not as closely tied to financial stability), such as consumer protection, promoting choice and other ‘conduct’ aspects, form a linked though distinct, aspect of the regulatory environment. This could be discharged in Scotland. The framework takes into consideration EU rules and requirements and, in particular, the opportunity for institutions legally established in other Member States to largely operate without further authorisation requirements throughout the EU (i.e. ‘passporting’).

There is merit in ensuring a degree of consistency given the broadly integrated financial services sector (both within the UK and increasingly Europe). Moreover, in certain areas it is recognised that there would be relatively strict alignment to satisfy commonality in related prudential areas to ensure financial stability across the Sterling Zone.

**Crisis Management and Resolution**

In addition to supervision and regulatory issues, the framework enshrines an effective resolution mechanism and protection scheme for deposits and other financial products.

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\(^9\) Macroprudential Regulation seeks to prevent the build-up of imbalances such as asset bubbles that pose a systemic threat to the Financial System. Microprudential Regulation seeks to ensure the soundness of individual firms within the economy.
3 Summary Macroeconomic Framework

3.52 Financial crises require close coordination of monetary, fiscal and macroprudential policy. At the centre of the framework is the proposition for issues of crisis management, resolution and deposit protection to be coordinated on a pan-Sterling Zone basis. This would be consistent with the powers and authority of the Bank of England under the UK Banking Act 2009 and would also reflect the integrated nature of the highly developed financial services market and the need for co-ordinated action to deal with cross border financial institutions. It would also be consistent with the emerging principles underpinning the proposed Banking Union in Europe.

3.53 While these activities, in all but the worst of financial crises, are likely to be conducted at arms-length from government, for example by the central bank and financial regulatory authorities. If and when any input was required from a fiscal authority – for example an indemnity was sought to underwrite a particular intervention – this could be coordinated through the ‘Macroeconomic Governance Committee’.

3.54 Depending upon the nature of the intervention this could be undertaken jointly by both governments in accordance with the shareholder framework as set out above. This would deliver a fair, common and effective approach to ensuring stability across an integrated financial and monetary area.

Fiscal Policy

3.55 Within this macroeconomic framework, fiscal policy would provide the key new levers for the government to grow the economy and to tackle challenges in Scottish society and Scotland’s economy.

3.56 In addition to aligning spending priorities and policies to the unique circumstances of the Scottish economy and the preferences of the people of Scotland, opportunities would exist to put in place new tax and economic regulatory systems.

3.57 It is clear that as a result of both the position on UK public finances prior to the financial crisis, and the scale of the negative impact of the downturn itself, Scotland and the UK will face a challenging fiscal envelope for at least the next 5 years irrespective of the constitutional framework.
3.58 This does however, present an opportunity to establish a new framework that promotes fiscal sustainability, learn the lessons of the past and put in place strong foundations of responsibility to underpin future growth and prosperity.

3.59 It is assumed that the Scottish Government would inherit a fair and equitable share of historic UK public sector liabilities and assets. There are complex legal issues surrounding transferring existing UK Government debt, particularly around the definition of ‘successor state’. A transitional arrangement whereby outstanding debt was gradually transferred to both countries while the Scottish Government continued to meet its share of existing obligations, would seem to be a sensible and efficient solution. There are various technical ways in which this could be achieved.

3.60 In order to promote stability within the proposed monetary union, there is merit in putting in place a fiscal sustainability agreement with overall objectives for ensuring that net debt and government borrowing do not diverge significantly. This should cover both governments and be credible. Within this overall envelope there would be the freedom to vary taxation and spending.

3.61 Given the relative importance of oil and gas revenues to the Scottish economy, and the prospects for volatility in revenues from this sector, the framework looks to incorporate a stability fund to manage oil revenues. The Scottish Government should plan budgets on a cautious estimate for oil revenues and invest any upside volatility in the form of higher tax revenues in such a fund. This could then be used to guard against future unexpected falls in revenue or asymmetric shocks. With careful management of the public finances over time, such a fund could evolve into a more general wealth fund to promote inter-generational equity.

3.62 In response to a previous recommendation from the Council of Economic Advisers in 2009, the Scottish Government agreed to establish an independent Fiscal Policy Commission alongside moves toward greater autonomy. As part of the framework, it is envisaged that this Commission would have a wider role than simply a body to oversee the transparency and robustness of economic forecasts, with a clear objective of advising on economic and fiscal policies. This would help provide credibility to markets and potential investors.
Scottish Monetary Institute

Related to this, and to ensure that fiscal policy decisions were fully informed of developments in the Scottish economy in areas such as monetary and financial stability, the Scottish Government should establish an independent Scottish Monetary Institute. This should be independent and transparent but accountable to the Scottish Government.

This institute could take responsibility for a number of key functions including, research into the Scottish economy, monitoring of developments in the financial sector and data collection. It would work closely with the Bank of England. There may also be a synergy from bringing together other key macroeconomic functions, such as debt management, in such an independent body.

It is envisaged that such an institute would also be a key focal point and reporting body for EU-wide institutions and structures and international organisations such as the IMF and the OECD. The gradual build-up of such institutions would also increase the flexibility and range of potential macroeconomic options for Scotland in the decades ahead.

Conclusion

The framework outlined above provides a broad overview of the proposition for a macroeconomic framework for an independent Scotland.

The proposed structure takes the status quo as a starting point. It is designed to be robust, flexible and attractive to key partners in the rest of the UK and the EU, while at the same time providing significant policy autonomy to Scotland. Ultimately the exact framework will be negotiated with these partners, and many of these discussions may not take place until after the referendum. However, the Fiscal Commission Working Group is confident that such a framework provides a basis for productive negotiations on an agreed way forward and can evolve in the light of changing circumstances.

From the perspective of the UK - if there is a vote for independence - the Working Group believe that this framework would be to their benefit. It would for example provide a consistent and transparent framework to manage the transition process. The UK would also retain an integrated market with a key trading partner. As approximately 10% of the
existing UK economy (roughly the size of the entire financial services industry in the UK), Scotland would remain one of the largest trading partners of the UK economy. There would be particular advantages for the UK in areas such as energy and financial services.

3.69 Moreover, the model proposed for monetary policy, financial stability and fiscal policy offers fully engineered frameworks in key areas of interest to the UK. For example, the proposals for financial stability would ensure that major financial institutions based in Scotland and operating in the rest of the UK would be subject to similar levels of oversight and scrutiny (and vice versa).

3.70 It has been claimed that a model of monetary union poses Euro Area style risks to Scotland. However, the proposed framework summarised above is quite different. It contains a number of mechanisms which overcome the design problems of the initial Euro Area model. It starts from an existing shared currency, and incorporates key elements of fiscal and financial stability policy, underpinned by two economies which are structurally, cyclically and institutionally more aligned than the members of the Euro Area.

3.71 It is designed to be flexible and evolve should the people of Scotland wish for further reform in the future or should economic conditions change post-independence.

3.72 The structure proposed however, would represent a major step change in the economic powers and responsibilities of the Scottish Parliament and Scottish Government. It would ultimately provide full control, in terms of economic sovereignty, to the people of Scotland.
3 Summary Macroeconomic Framework
Chapter Summary

- By international standards Scotland is a wealthy and productive country.

- Excluding North Sea oil output, GVA per head of population in Scotland is estimated to be approximately 99% of the UK average and the highest in the UK outside London and the South East.

- When the value of North Sea output is added, the size of the Scottish economy increases by around 20%.

- However over the last few decades, Scotland’s economic growth rate has lagged behind that of many of its peers. For example, over the thirty year period prior to the onset of the financial crisis, average economic growth per annum in Scotland was estimated to be around 0.5 percentage points a year slower than in the UK.

- While progress has been made in recent years, there is no obvious characteristic of the Scottish economy that explains this underperformance.

- Many countries of a comparable size and structure have used the full spectrum of policy levers to perform more successfully across a range of social and economic indicators in the long run.

- The Scottish Government believes that independence is the key to fully unlocking Scotland’s potential and escaping the limitations of the current constitutional framework.

Introduction

4.1 This chapter provides a short summary of the Scottish economy and Scotland’s macroeconomic performance relative to both the UK and other independent nations.

4.2 Trends in key economic data can highlight how suited a country is to a particular macroeconomic framework – for example a currency union – and also what opportunities (and challenges) may emerge from a particular proposal.
4 The Scottish Economy

4.3 Many of these concepts will be developed in later chapters.

4.4 At an aggregate level, the Scottish economy performs strongly on key indicators. However in certain areas, in particular in relation to the long-term drivers of growth and business development, Scotland has lagged behind many of its competitors and there is scope for improvement. This relative under-performance has persisted for decades.

<table>
<thead>
<tr>
<th>Table 4.01: Key Facts: Scotland and the UK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scotland</strong></td>
</tr>
<tr>
<td>Population (million), 2011</td>
</tr>
<tr>
<td>GDP Per capita (US$), 2010</td>
</tr>
<tr>
<td>Including geographical share of North Sea output</td>
</tr>
<tr>
<td>Unemployment Rate (%), Sep-Nov 2012</td>
</tr>
<tr>
<td>Net Fiscal Balance (% of GDP), 2010-11</td>
</tr>
<tr>
<td>Source: Scottish Government, Office for National Statistics (ONS), OECD</td>
</tr>
</tbody>
</table>

4.5 In addition, Scotland is currently part of a UK society where levels of inequality are relatively high. In recent decades, income inequalities have grown in the UK.

4.6 However, the vast majority of the important policy levers that can tackle these issues are reserved to the UK Government. Independence would provide the opportunity for tailoring Scottish policy responses to Scottish economic conditions. It would be the responsibility of the Scottish Government to ensure whether these policies are used optimally or not.

4.7 This chapter provides a summary of the key economic data on the Scottish economy.

Economic Statistics in Scotland

4.8 Both the Scottish Government and the Office for National Statistics (ONS) publish a range of macroeconomic statistics for Scotland. This enables benchmark comparisons to be made.

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10 Includes an illustrative geographical share of North Sea revenues
11 Updates on the Scottish economy are provided on a regular basis in the Scottish Government’s State of the Economy publication available at: [http://www.scotland.gov.uk/Topics/Economy/state-economy](http://www.scotland.gov.uk/Topics/Economy/state-economy).
However as much of the statistical collection is undertaken at a UK level, the data coverage for Scotland is more limited than for independent nations of a comparable size.

The Scottish Government is taking forward a programme of development in economic statistics to help improve the knowledge and understanding of the Scottish economy – see Box 4.01.

Box 4.01: Scottish Economic Statistics – Development Work

The Scottish Government and ONS produce a range of economic statistics for Scotland, many of which are classified as National Statistics.

Key economic statistics currently available for Scotland include:

- Quarterly GDP Growth;
- Exports of Goods and Services (Global Connections Survey);
- Labour Market;
- Business and energy statistics;
- Input Output Tables and Multipliers;
- National Accounts (Experimental); and,
- Public Sector Accounts (Government Expenditure and Revenue Scotland).

Alongside this, a range of organisations such as Scottish Engineering, Scottish Chambers of Commerce and Bank of Scotland/Lloyds Banking Group, publish a variety of short-term indicators including monthly business surveys.

There are however, important gaps in the economic statistics available at the distinctly Scottish level. In many cases this reflects the fact that companies’ economic activities are not reported at a sub-UK level.

The Scottish Government is taking forward a scoping exercise to explore potential methodologies to expand the range of statistics produced for Scotland. Such development work is vital to improving the understanding of the Scottish economy, irrespective of the constitutional settlement.

This work will investigate the potential opportunities to produce the following economic statistics for Scotland:

- Gross National Income;
4 The Scottish Economy

- Balance of Payments Current Account;
- North Sea output and economic flows; and,
- Offshore Input-Output Satellite Account.

As this work progresses, working papers and datasets will be published on the Scottish Government Economic Statistics website for stakeholder input\[^{12}\].

Anyone interested in participating in this development process should use the contact details on the website.

Key Facts

4.11 Scotland’s population as at March 2011 was estimated to be 5.295 million – approximately 8.4% of the UK total\[^{13}\]. In 2011, Scottish onshore GDP amounted to £124 billion\[^{14}\] - approximately 8.2% of the UK total\[^{15}\].

4.12 Under existing UK National Accounts conventions, output and tax revenues from the North Sea are classified as extra-regio (a hypothetical region within the UK).

4.13 With the inclusion of an illustrative geographical share of North Sea output, the Scottish economy increases by around 20% to £149 billion\[^{16}\], which is equivalent to 9.9% of the UK total in 2011. An illustrative geographical boundary for Scotland is highlighted in Figure 4.01 below.


\[^{13}\] 2011 Census: First Results on Population Estimates for Scotland - Release 1A, National Records of Scotland, December 2012,
[www.scotlandscensus.gov.uk/documents/censusresults/release1a/re1asb.pdf](http://www.scotlandscensus.gov.uk/documents/censusresults/release1a/re1asb.pdf)

\[^{14}\] Scottish National Accounts Project (SNAP)

\[^{15}\] UK GDP at current market prices, includes extra regio output, ONS

\[^{16}\] Scottish National Accounts Project (SNAP)
4.14 The size of the Scottish economy is not dissimilar to many other advanced and successful independent countries.

4.15 Of the 34 advanced economies, as defined by the IMF, 23 have populations of less than 20 million and 10 have populations of less than in Scotland.
Table 4.02: 2011 Advanced Economy Population Comparisons (‘000s)

<table>
<thead>
<tr>
<th>Country</th>
<th>Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scotland</td>
<td>5,295</td>
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<tr>
<td>Iceland</td>
<td>319</td>
</tr>
<tr>
<td>Malta</td>
<td>419</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>517</td>
</tr>
<tr>
<td>Cyprus</td>
<td>1,117</td>
</tr>
<tr>
<td>Estonia</td>
<td>1,340</td>
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<tr>
<td>Slovenia</td>
<td>2,052</td>
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<tr>
<td>New Zealand</td>
<td>4,405</td>
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<tr>
<td>Ireland</td>
<td>4,487</td>
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<tr>
<td>Norway</td>
<td>4,952</td>
</tr>
<tr>
<td>Singapore</td>
<td>5,184</td>
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<tr>
<td>Finland</td>
<td>5,387</td>
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<tr>
<td>Slovak Republic</td>
<td>5,440</td>
</tr>
<tr>
<td>Denmark</td>
<td>5,574</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>7,072</td>
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<tr>
<td>Israel</td>
<td>7,766</td>
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<tr>
<td>Switzerland</td>
<td>7,907</td>
</tr>
<tr>
<td>Austria</td>
<td>8,419</td>
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<tr>
<td>Iceland</td>
<td>319</td>
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<td>Malta</td>
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<td>Luxembourg</td>
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<td>Cyprus</td>
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<tr>
<td>Estonia</td>
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<td>2,052</td>
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<td>Ireland</td>
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<td>Norway</td>
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<td>Singapore</td>
<td>5,184</td>
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<td>Finland</td>
<td>5,387</td>
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<tr>
<td>Slovak Republic</td>
<td>5,440</td>
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<tr>
<td>Denmark</td>
<td>5,574</td>
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<tr>
<td>Hong Kong</td>
<td>7,072</td>
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<tr>
<td>Israel</td>
<td>7,766</td>
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<tr>
<td>Switzerland</td>
<td>7,907</td>
</tr>
<tr>
<td>Austria</td>
<td>8,419</td>
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</tbody>
</table>

Source: World Bank, ONS

Economic Prosperity

4.16 By international standards Scotland is a wealthy country.

4.17 The latest figures show Scotland with an output per head (i.e. GVA per head) of £20,571 (excluding North Sea output) in 2011 – see Table 4.03. This is approximately 99% of the UK average of £20,873. In 2011, Scotland was ranked third out of the 12 UK nations and English regions after London and the South East.

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17 GVA per head is the most widely recognised measure of relative living standards. GVA is GDP at basic prices. Figures are from the December 2012 Regional Gross Value Added (Income Approach) release, ONS

18 Based on December 2012 Regional Gross Value Added (Income Approach) release, ONS
4.18 Adding Scotland’s illustrative geographical share of North Sea output increases Scottish GDP per head to around 115% of the UK average\(^\text{19}\).

4.19 Other measures of relative economic performance, such as household income per head, show similar trends\(^\text{20}\). In 2010, gross disposable household income per head in Scotland was estimated to be 98% of the UK (less extra-regio) average - up from around 93% at the start of devolution\(^\text{21}\).

<table>
<thead>
<tr>
<th>Table 4.03: NUTS 1 UK Regional GVA(^\text{A,B}2011)^(^\text{C})</th>
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</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>GVA per head</strong> ((£))</td>
</tr>
<tr>
<td>---------------------------</td>
</tr>
<tr>
<td>United Kingdom(^\text{D})</td>
</tr>
<tr>
<td>North East</td>
</tr>
<tr>
<td>North West</td>
</tr>
<tr>
<td>Yorkshire &amp; The Humber</td>
</tr>
<tr>
<td>East Midlands</td>
</tr>
<tr>
<td>West Midlands</td>
</tr>
<tr>
<td>East of England</td>
</tr>
<tr>
<td>London</td>
</tr>
<tr>
<td>South East</td>
</tr>
<tr>
<td>South West</td>
</tr>
<tr>
<td>England</td>
</tr>
<tr>
<td>Wales</td>
</tr>
<tr>
<td>Scotland</td>
</tr>
<tr>
<td>Northern Ireland</td>
</tr>
<tr>
<td>Extra-Regio</td>
</tr>
</tbody>
</table>

Source: ONS
A - GVA at current basic prices on workplace basis, based on weighted 5-year moving average
B - Figures may not sum to totals due to rounding
C – These 2011 estimates are provisional
D - Per head and per head index figures exclude statistical discrepancy and Extra-Regio: off-shore contribution to GVA that cannot be assigned to any region

4.20 Table 4.04 extends this per capita analysis to the top-25 OECD countries.

\(^{19}\) Based on SNAP, UKEA and population figures using the last GERS publication. Comparisons of GDP per capita including North Sea oil should be viewed with caution as much of the output from the North Sea flows overseas. An alternative measure that accounts for this is Gross National Income (GNI). However, tax revenues represent an especially large share of North Sea output and therefore the difference between GNI and GDP including North Sea output for Scotland may not be as large as some commentators have suggested.

\(^{20}\) Gross Disposable Household Income (GDHI) measures the impact of economic growth on household income Scottish National Accounts Project (SNAP) has recently published estimates for Scotland of this indicator. See [http://www.scotland.gov.uk/snap](http://www.scotland.gov.uk/snap)

\(^{21}\) Scottish National Accounts Project (SNAP)
Table 4.04: OECD GDP per capita ($US, current prices, current PPPs), 2010

<table>
<thead>
<tr>
<th>Rank</th>
<th>2010 GDP per capita</th>
<th>Index (USA=100)</th>
<th>Rank</th>
<th>2010 GDP per capita</th>
<th>Index (USA=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Luxembourg</td>
<td>86,226</td>
<td>14</td>
<td>Finland</td>
<td>36,477</td>
</tr>
<tr>
<td>2</td>
<td>Norway</td>
<td>57,231</td>
<td>15</td>
<td>United Kingdom</td>
<td>35,715</td>
</tr>
<tr>
<td>3</td>
<td>Switzerland</td>
<td>46,622</td>
<td>16</td>
<td>Iceland</td>
<td>35,642</td>
</tr>
<tr>
<td>4</td>
<td>United States</td>
<td>46,588</td>
<td>17</td>
<td>France</td>
<td>34,148</td>
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<tr>
<td>5</td>
<td>Netherlands</td>
<td>42,175</td>
<td>18</td>
<td>Japan</td>
<td>33,751</td>
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<td>6</td>
<td>Australia</td>
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<td>Italy</td>
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<td>7</td>
<td>Ireland</td>
<td>40,458</td>
<td>20</td>
<td>Spain</td>
<td>31,888</td>
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<td>8</td>
<td>Denmark</td>
<td>40,170</td>
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<td>New Zealand</td>
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<td>9</td>
<td>Austria</td>
<td>40,017</td>
<td>22</td>
<td>Korea</td>
<td>29,101</td>
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<tr>
<td>10</td>
<td>Sweden</td>
<td>39,326</td>
<td>23</td>
<td>Israel</td>
<td>28,596</td>
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<tr>
<td>11</td>
<td>Canada</td>
<td>39,070</td>
<td>24</td>
<td>Greece</td>
<td>28,430</td>
</tr>
<tr>
<td>12</td>
<td>Belgium</td>
<td>37,676</td>
<td>25</td>
<td>Slovenia</td>
<td>26,928</td>
</tr>
<tr>
<td>13</td>
<td>Germany</td>
<td>37,411</td>
<td>80.3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD

4.21 The Scottish Government has previously published estimates of where Scotland would rank in terms of GDP per capita against OECD member countries.

4.22 This analysis estimated that when an illustrative geographic share of North Sea (extra regio) output is included in Scottish Gross Domestic Product (GDP), then when compared against 34 OECD member countries, Scotland would have been ranked 6th with regards to GDP per capita in 2010. Rankings vary from year to year, but it is expected that Scotland will continue to retain a high ranking for the near future.

23 Rankings based on 2011 data will be updated once fully revised SNAP data becomes available in Spring 2013. Current SNAP data will be revised to reflect the methodological improvements to the Scottish GVA series published on 1st February 2013
Employment and Earnings

4.23 Scotland also performs relatively strongly on other key macroeconomic indicators – such as the labour market – with the rate of employment and unemployment in Scotland and the UK broadly aligned.

<table>
<thead>
<tr>
<th>Table 4.05: UK Labour Market (Sep – Nov 2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment Rate (Aged 16-64)</td>
</tr>
<tr>
<td>-----------------------------</td>
</tr>
<tr>
<td>England</td>
</tr>
<tr>
<td>Wales</td>
</tr>
<tr>
<td>Scotland</td>
</tr>
<tr>
<td>Northern Ireland</td>
</tr>
<tr>
<td>UK</td>
</tr>
</tbody>
</table>

Source: ONS

4.24 Workplace based earnings in Scotland are slightly lower than in the rest of the UK. Median gross annual earnings data for all workers in 2012 shows that pay in Scotland was 2.4% lower than in the UK as a whole. This reflects, in part, the outlier of pay awards in London and in particular the City. Indeed annual gross earnings are higher in Scotland than in all 12 UK government office regions, apart from London and the South East of England.

4.25 The ‘savings-ratio’ provides an indication of the amount of savings that households make in relation to available resources. Scotland’s household savings ratio has been higher than that at the UK level. See Chart 4.01.

4.26 It could be argued that this estimated higher savings ratio may put Scotland in a stronger position than the rest of the UK when the economy gathers momentum as Scottish households will be in a better position in relation to their relative debt levels.

24 Annual Survey of Hours and Earnings (ASHE). ONS
Inflation and Prices

4.27 Data on price differentials and inflation rates in Scotland and other parts of the UK are relatively limited. Unlike some countries, separate regional price indices are not provided in the UK on a regular basis. In 2010 however, ONS updated previous analysis of regional price levels in the UK. This estimated the price level in Scotland to be 99% of the UK figure. London was unsurprisingly an outlier.
4.28 One area where there is more of a divergence, is in house prices. Whilst over the long-term term, house prices have tended to follow a similar trend, the UK – driven primarily by London and the South East – has had a greater susceptibility to house price bubbles. See Chart 4.03.

4.29 Historically there have been structural differences between the Scottish and UK housing markets, although these differences have narrowed over the last two decades. For example, home ownership in Scotland has increased significantly to broadly converge with the UK. In 2011, 63.9% of all dwellings in Scotland were owner occupied, compared to 64.7% in the UK. One characteristic of the Scottish housing stock is that the social rent sector is more significant, accounting for 24% of dwellings compared to 18% in the UK.

---

25 Chart 4.02: Regional price level relative to national price level in 2010 (UK=100)

Source: ONS


4.29 Nationwide Regional House Price Series

27 Social sector housing stock includes properties owned by local authorities or housing associations
Assessments of Scotland’s long-term growth performance can be challenging, particularly when drawing comparisons with other economies.

Growth rates can be influenced by a variety of factors, including economic ‘catch-up’ and methodological differences. Care should also be exercised when using past performance to infer prospects about future growth. This is particularly true when assessing the impact of a major policy or institutional change, such as independence.

Comparisons of historical growth trends between Scotland and its major peers do however, provide a useful assessment of Scotland’s performance within the current constitutional framework.

In this regard, it is widely accepted that, in terms of economic growth, Scotland has underperformed relative to both the UK and other small EU countries.

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28 This refers to the phenomenon whereby countries with initially lower levels of GDP grow more quickly over a given period of time as their economy moves to a more balanced growth path.

29 The group of Small EU Countries used for comparison are: Austria, Denmark, Finland, Ireland, Luxembourg, Portugal, and Sweden.
For example, over the 30-year period up to the financial crisis (1977 to 2007), economic growth in Scotland averaged 2.3% per annum compared to 2.8% for the UK.

### Table 4.06: Average Annual GDP Growth Rates

<table>
<thead>
<tr>
<th>Period</th>
<th>Average Annual GDP Growth</th>
<th>Gap (Scotland minus UK/Small EU)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Scotland</td>
<td>UK</td>
</tr>
<tr>
<td>1977-2007</td>
<td>2.3%</td>
<td>2.8%</td>
</tr>
<tr>
<td>1998-2007</td>
<td>2.9%</td>
<td>3.1%</td>
</tr>
<tr>
<td>1998-2011</td>
<td>1.8%</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

Source: Scottish Government, ONS, OECD (Note differences may be due to rounding)

When considered over more recent periods – for example the last five years – the average gap in performance has been less pronounced and the performance over the recession has been broadly in line, if not marginally better.

### Chart 4.04: Scottish and UK performance over Recession

Source: Scottish Government, ONS

Since 2008, the performance of both the Scottish and UK economies has been broadly similar. During the 2008/09 recession, output fell by 5.6% in Scotland compared to 6.3% for the UK.

---

36 Data for illustrative purposes only. Scottish data prior to 1998 are estimated by applying a UK SIC 07 to SIC 03 ratio to historic Scottish GVA figures
The Scottish Economy

The recovery has however been slightly faster in the UK vis-à-vis Scotland. Overall, any differences have been relatively minor.

Drivers of Growth

4.37 In the short run, economies are influenced by a wide combination of demand and supply side factors both temporary and structural.

4.38 Over the long-term however, it is generally accepted that the growth rate of an economy depends upon key supply-side drives – Productivity, Participation and Population.

4.39 Improving productivity is regarded as the principle long-term driver of growth in an advanced economy. A more productive economy can typically enjoy higher living standards.

4.40 Gross Value Added (GVA) per hour worked provides a transparent measure of labour productivity that can be easily assessed and compared across countries.

Chart 4.05: GVA per Hour Worked – UK and Scotland, 2011

Source: ONS

---

As Chart 4.05 highlights, labour productivity in Scotland is estimated to be broadly in line with the UK average – and 3rd behind London and the South East in 2011. Scotland has particular strengths in key sectors.

In 2011, in terms of productivity performance Scotland was 97% of the UK average in terms of GVA per hour worked and 99% of the UK average in terms of GVA per filled job.

Chart 4.06: GDP per hour worked, 2011 – International Comparisons

Source: OECD, ONS

However when the comparison is widened to include international competitors, Scotland’s (and the UK’s) performance is less favourable.

Despite improving in recent years, UK and Scottish labour productivity levels still lag behind key competitors such as the US, Germany and France.32

Labour force participation is also a key determinant of long-run economic growth and an important avenue through which inequalities can be tackled.

As highlighted above, over the last decade the Scottish labour market has performed relatively strongly both in comparison to other parts of the UK and internationally.

---

The recession however, has impacted on the labour markets of almost every advanced economy. Unemployment in Scotland is currently well above trend. Employment and unemployment rates – across age groups, gender and part-time/full-time – are now broadly aligned between Scotland and the UK.

**Chart 4.07: Employment Scotland and UK**

Population growth – particularly growth in those of working age – is not just important for explaining past economic performance, it is arguably one of the most significant challenges facing many countries.

Across advanced economies, there is a trend toward an ageing population. In addition to reducing the working capacity of an economy, this can lead to pressures on key public services.

As Chart 4.08 below highlights, while the population in the UK has been rising on a consistent basis for the past 40 years, for most of the same period, Scotland’s population was in decline.
4.51 However, there is growing evidence that the efforts of successive Scottish administrations to boost Scotland’s population are starting to have an impact.

4.52 The 2011 Census estimates – published December 2012 – show that as at March 2011 Scotland’s population stood at 5.295 million. This is the highest ever population in Scotland.

4.53 The latest population projections – based on the 2010 mid-year population estimate – suggest that Scotland’s population is likely to continue to grow over the period to 2035. Scotland’s working age population is also forecast to increase over the period, although at a slightly lower rate than the UK.\(^{33}\)

4.54 The data on migration highlights that in and out migration with the rest of the UK still represents Scotland’s largest flows. However, a significant driver of the recent boost to Scotland’s population has been an inflow of non-UK migrants to Scotland – see Chart 4.10.

\(^{33}\) ONS Population Projection. Mid-2010 based
4 The Scottish Economy

Chart 4.09: Migration to and from UK, 1981-2011

Source: National Records of Scotland 2011 Annual Report

Chart 4.10: Migration to and from overseas, 1991 – 2011

Source: National Records of Scotland 2011 Annual Report

4.55 The variations in population trends between Scotland and the UK is arguably one area where there is the most significant difference between the two countries, and the greatest

34 http://www.gro-scotland.gov.uk/files2/stats/high-level-summary/j11198/j1119807.htm
35 Figures shown here are from the Long-Term International Migration (LTIM) series produced by the ONS
scope for policy divergence and gains from autonomy to be made. It is also an area where a substantial difference could be made to Scotland’s growth prospects.

4.56 In 2010, Scotland’s dependency ratio was estimated to have been lower than in the UK. Dependency ratios show the number of dependants (children aged under 16 and people of pensionable age) per 1,000 working age population. The ratios for Scotland and the UK are shown in Chart 4.11.

4.57 The analysis shows that whilst there is expected to be little change in the gap between the Scottish and UK ratios over the next 15-20 years, from 2026 it is projected that without action, Scotland’s dependency ratio will increase more rapidly compared to the UK – reflecting the particularly sharp increase in Scotland’s pension age population – resulting in the dependency ratios in Scotland and the UK converging.

Chart 4.11: Dependency Ratio for Scotland and the UK

Source: ONS Population Projections

Inequality

4.58 A central feature of the Scottish Government’s approach to economic growth – set out in the Government’s Economic Strategy – is the recognition that certain characteristics of

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36 These ratios take account of the increase in the pensionable age for both men and women
37 http://www.scotland.gov.uk/ges
growth in terms of an economy’s ability to tackle inequalities and ensure sustainability, are just as important as boosting overall growth.

4.59 Gini coefficients are the most widely used measure of inequality in household incomes and range between 0 and 1 with higher Gini values indicating a more unequal society. When compared against other advanced economies, the UK has relatively high levels of inequality. The most recent estimates for 2010-11 show that Scotland’s Gini coefficient (0.30) is lower than the comparable figure for the UK as a whole (0.34). While closer to the OECD average than the UK, Scotland is still more unequal than many other countries. In a survey of countries, albeit for different years in the late 2000s, the OECD estimates that the UK ranked 28th out of 34 OECD countries in terms of its Gini coefficient. Denmark and Norway were ranked second and third respectfully with coefficients around 0.25.

4.60 A number of economists have argued that inequality can have adverse impacts on both economic performance and social well-being. For example, in his analysis on the links between inequality and growth, Professor Joseph Stiglitz concludes that countries which are more unequal do not do as well, do not grow as well and are less stable. Professor Stiglitz’s analysis suggests that a concentration of income can restrict the economy in the long-run by limiting the potential of people to contribute in a productive way; whilst inequality may also restrict government investment in infrastructure, education, and technology that is required by a modern economy. Long-standing labour market underperformance in some regions can also act to reinforce patterns of economic performance and constrain a nation’s full economic potential.

---


<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Gini Coefficient</th>
<th>Rank</th>
<th>Country</th>
<th>Gini Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Slovenia</td>
<td>0.236</td>
<td>18</td>
<td>Poland</td>
<td>0.305</td>
</tr>
<tr>
<td>2</td>
<td>Denmark</td>
<td>0.248</td>
<td>19</td>
<td>Greece</td>
<td>0.307</td>
</tr>
<tr>
<td>3</td>
<td>Norway</td>
<td>0.25</td>
<td>20</td>
<td>Korea</td>
<td>0.314</td>
</tr>
<tr>
<td>4</td>
<td>Czech Republic</td>
<td>0.256</td>
<td>21</td>
<td>Estonia</td>
<td>0.315</td>
</tr>
<tr>
<td>5</td>
<td>Slovak Republic</td>
<td>0.257</td>
<td>22</td>
<td>Spain</td>
<td>0.317</td>
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<tr>
<td>6</td>
<td>Belgium</td>
<td>0.259</td>
<td>23</td>
<td>Canada</td>
<td>0.324</td>
</tr>
<tr>
<td>7</td>
<td>Finland</td>
<td>0.259</td>
<td>24</td>
<td>Japan</td>
<td>0.329</td>
</tr>
<tr>
<td>8</td>
<td>Sweden</td>
<td>0.259</td>
<td>25</td>
<td>New Zealand</td>
<td>0.33</td>
</tr>
<tr>
<td>9</td>
<td>Austria</td>
<td>0.261</td>
<td>26</td>
<td>Australia</td>
<td>0.336</td>
</tr>
<tr>
<td>10</td>
<td>Hungary</td>
<td>0.272</td>
<td>27</td>
<td>Italy</td>
<td>0.337</td>
</tr>
<tr>
<td>11</td>
<td>Luxembourg</td>
<td>0.288</td>
<td>28</td>
<td>United Kingdom</td>
<td>0.342</td>
</tr>
<tr>
<td>12</td>
<td>France</td>
<td>0.293</td>
<td>29</td>
<td>Portugal</td>
<td>0.353</td>
</tr>
<tr>
<td>13</td>
<td>Ireland</td>
<td>0.293</td>
<td>30</td>
<td>Israel</td>
<td>0.371</td>
</tr>
<tr>
<td>14</td>
<td>Netherlands</td>
<td>0.294</td>
<td>31</td>
<td>United States</td>
<td>0.378</td>
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<tr>
<td>15</td>
<td>Germany</td>
<td>0.295</td>
<td>32</td>
<td>Turkey</td>
<td>0.409</td>
</tr>
<tr>
<td>16</td>
<td>Iceland</td>
<td>0.301</td>
<td>33</td>
<td>Mexico</td>
<td>0.476</td>
</tr>
<tr>
<td>17</td>
<td>Switzerland</td>
<td>0.303</td>
<td>34</td>
<td>Chile</td>
<td>0.494</td>
</tr>
</tbody>
</table>

Source: OECD

4.61 Despite continued economic growth and improving labour market conditions, there is evidence that the growth in income inequality has widened over the past 35 years in the UK. Indeed, 2011 OECD research found that since 1975 income inequality among working-age people increased more quickly in the UK than in any other OECD country.  

4.62 Without access to the relevant policy levers – particularly taxation and welfare policy – there is little that the Scottish Government can do to address these trends.

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41 Latest data from OECD on international Gini comparisons. Data not available for same year for all countries, so presented as late-2000s

Box 4.02: National Performance Framework

Following the recommendations of the Commission on the Measurement of Economic Performance and Social Progress in 2009\(^\text{43}\) - which was chaired by Professors Stiglitz, Sen, and Fitoussi - there is now increased focus on wider measures of progress. This has prompted a shift away from solely focusing on traditional economic statistics such as GDP towards consideration of a broader set of measures of individual and societal well-being.

Scotland starts from a strong position in this area. The National Performance Framework (NPF)\(^\text{44}\) sets out, through an outcomes-based approach, the Scottish Government’s long-term vision for the kind of Scotland that it wants to see. There are 61 indicators in the NPF that provide a broad measure of national and societal well-being, incorporating a range of economic, social and environmental indicators and targets.

The NPF provides the Scottish Government with a sound basis to support decision making and the coherent development of policy. It also provides a clear and current guide on the state of the economy which can be used to assess the impact of policy.


Progress against the measures set out in the NPF are measured in a comprehensive, impartial and transparent way through the Scotland Performs website at:
http://www.scotland.gov.uk/About/Performance/scotPerforms.

4.63 The United Nation’s Human Development Index (HDI) provides a measure of development across countries through a composite index based on indicators of life expectancy, educational attainment, and income. The top ranked country in the 2011 HDI was Norway, whilst Ireland (7th), Sweden (10th), Switzerland (11th), Iceland (14th), Denmark (16th), and Austria (19th) were all ranked in the top 20. The UK was ranked 28th in the 2011 HDI.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>HDI</th>
<th>Rank</th>
<th>Country</th>
<th>HDI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Norway</td>
<td>0.943</td>
<td>16</td>
<td>Denmark</td>
<td>0.895</td>
</tr>
<tr>
<td>2</td>
<td>Australia</td>
<td>0.929</td>
<td>17</td>
<td>Israel</td>
<td>0.888</td>
</tr>
<tr>
<td>3</td>
<td>Netherlands</td>
<td>0.910</td>
<td>18</td>
<td>Belgium</td>
<td>0.886</td>
</tr>
<tr>
<td>4</td>
<td>United States</td>
<td>0.910</td>
<td>19</td>
<td>Austria</td>
<td>0.885</td>
</tr>
<tr>
<td>5</td>
<td>New Zealand</td>
<td>0.908</td>
<td>20</td>
<td>France</td>
<td>0.884</td>
</tr>
<tr>
<td>6</td>
<td>Canada</td>
<td>0.908</td>
<td>21</td>
<td>Slovenia</td>
<td>0.884</td>
</tr>
<tr>
<td>7</td>
<td>Ireland</td>
<td>0.908</td>
<td>22</td>
<td>Finland</td>
<td>0.882</td>
</tr>
<tr>
<td>8</td>
<td>Liechtenstein</td>
<td>0.905</td>
<td>23</td>
<td>Spain</td>
<td>0.878</td>
</tr>
<tr>
<td>9</td>
<td>Germany</td>
<td>0.905</td>
<td>24</td>
<td>Italy</td>
<td>0.874</td>
</tr>
<tr>
<td>10</td>
<td>Sweden</td>
<td>0.904</td>
<td>25</td>
<td>Luxembourg</td>
<td>0.867</td>
</tr>
<tr>
<td>11</td>
<td>Switzerland</td>
<td>0.903</td>
<td>26</td>
<td>Singapore</td>
<td>0.866</td>
</tr>
<tr>
<td>12</td>
<td>Japan</td>
<td>0.901</td>
<td>27</td>
<td>Czech Republic</td>
<td>0.865</td>
</tr>
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<td>13</td>
<td>Hong Kong, China (SAR)</td>
<td>0.898</td>
<td>28</td>
<td>United Kingdom</td>
<td>0.863</td>
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<tr>
<td>14</td>
<td>Iceland</td>
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<td>29</td>
<td>Greece</td>
<td>0.861</td>
</tr>
<tr>
<td>15</td>
<td>Korea (Republic of)</td>
<td>0.897</td>
<td>30</td>
<td>United Arab Emirates</td>
<td>0.846</td>
</tr>
</tbody>
</table>

4 The Scottish Economy

Structure of the Scottish Economy

4.64 The Scottish economy is a modern, advanced economy with key international strengths across a range of diverse sectors and companies.45

4.65 As with many advanced economies, there has been a general shift in the Scottish economy from Manufacturing toward Service sector industries. Overall, the Service sector now accounts for approximately 72% of total output and 81% of employment.

4.66 The structure of the Scottish economy is broadly similar to the UK. The main differences are the higher share of Government and Other Services in Scotland (25.7% vs. 23.3%) and a lower share of Business Services & Finance (25.4% vs. 29.1%).

45 www.scotland.gov.uk/Topics/Business-Industry
Table 4.09 illustrates that the relative shares of total output per sector – production, construction and service sectors – are very similar.
4 The Scottish Economy

<table>
<thead>
<tr>
<th>Table 4.09: Structure of the Scottish and UK Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>-------------------------------</td>
</tr>
<tr>
<td>Production</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>Services</td>
</tr>
</tbody>
</table>

4.68 There are some differences however, within sectors, such as the importance of the oil and gas industry in Scotland – both offshore and the onshore supply chain – and the relatively high proportion of total UK activity in diverse sectors from fishing to life insurance located in Scotland.

Business Base and Openness to Trade

4.69 Growing Scotland’s business base – and making it more innovative and export orientated – has been a key priority for successive governments in Scotland.

4.70 Scotland’s relatively smaller business base (see Table 4.10), low business start-up rate and lower levels of business expenditure on research and development, have been identified as key challenges facing the Scottish economy. In addition, the gradual loss of major headquarter functions and associated spill-over benefits to the wider economy has also been a major concern. However, Scotland still hosts the headquarters of 7 FTSE 100 companies\(^{47}\), which is broadly in line with its share of the UK population.

4.71 The structure of the business base in Scotland is broadly similar to that of the UK, although there are some key differences in the structure of the business stock. In particular, the significance of large companies in the Scottish economy is greater than for the UK as a whole.

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\(^{46}\) Relative share of output can be estimated by the weight of the sector in the overall GDP index

\(^{47}\) This figure would increase to 8 if Lloyds Banking Group - who are headquartered in London, but whose registered office is in Scotland – are included
Table 4.10: Private sector business stock (registered and unregistered) per 10,000 adults, by size, UK and Scotland

<table>
<thead>
<tr>
<th>Country</th>
<th>Resident Adults Mid-year 2011</th>
<th>Private Sector Enterprises</th>
<th>Private Sector per 10,000 adults</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Enterprise Size (number of employees)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Small (0-49)</td>
</tr>
<tr>
<td>UK</td>
<td>51,269,800</td>
<td>4,794,105</td>
<td>928</td>
</tr>
<tr>
<td>Scotland</td>
<td>4,341,500</td>
<td>334,025</td>
<td>757</td>
</tr>
</tbody>
</table>


4.72 Business Enterprise Research and Development (BERD) in Scotland is typically concentrated in a small number of large companies – with the top 5 firms accounting for just over a fifth of Scottish R&D employment in 2011. Overall, the value of BERD undertaken in Scotland in 2011 (£689 million) was only 4.0% of the UK total (£17.4 billion) - well below a per capita share.

4.73 In terms of Gross Expenditure on Research and Development (GERD), which includes businesses, higher education and government expenditure, Scotland performs better. This reflects the strength of the university sector in Scotland. However, Scottish expenditure as a proportion of GDP is still below the EU average.

Chart 4.14: Gross Expenditure on Research and Development (GERD) 2001-2010

Source: Scottish Government, OECD
Scotland is an open economy, with extensive trade links both with the rest of the UK and the rest of the world.

Chart 4.15: Value of International Exports

Source: Global Connections Survey, Scottish Government

The pattern of Scotland’s international export activity reflects modern-day economic integration and the growing interdependencies of advanced economies. It also reflects geographic proximity.

Excluding oil and gas, Scottish international exports in 2011 were estimated to be worth around £23.9 billion. The EU is Scotland’s main trading partner, with around 46% of all international exports destined for the EU in 2011.

Scotland also conducts a significant part of its trade with the rest of the UK, amounting to around £45.5 billion, or approximately two-thirds of total exports.

Given Scotland’s position as a high-wage developed economy, Scottish exporters tend to find comparative advantage in high value-added sectors (see Chart 4.16), such as electrical & instrument engineering, financial services and niche products like whisky (which constitutes a large proportion of exports from the food & drink sector).
Chart 4.16: Top 10 International Exports by Sector, 2011

<table>
<thead>
<tr>
<th>Sector</th>
<th>Share of International Exports (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food &amp; Drink</td>
<td>18%</td>
</tr>
<tr>
<td>Coke, Petroleum &amp; Chemical Products</td>
<td>15%</td>
</tr>
<tr>
<td>Computer, Electronic &amp; Optical Products</td>
<td>6%</td>
</tr>
<tr>
<td>Financial &amp; Insurance</td>
<td>6%</td>
</tr>
<tr>
<td>Legal, Accounting &amp; Management</td>
<td>6%</td>
</tr>
<tr>
<td>Machinery &amp; Equipment</td>
<td>6%</td>
</tr>
<tr>
<td>Wholesale, Retail &amp; Vehicle Repair</td>
<td>5%</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>4%</td>
</tr>
<tr>
<td>Transport Equipment</td>
<td>4%</td>
</tr>
<tr>
<td>Transportation &amp; Storage</td>
<td>3%</td>
</tr>
</tbody>
</table>

Source: Global Connections Survey, Scottish Government

4.79 In accordance with National Accounting principles total Scottish exports do not include any exports of oil and gas extraction from the UK continental shelf. Scotland’s oil and gas reserves would also make a significant contribution to the Scottish economy post-independence, not least in its trade position. For example, Oil and Gas UK\(^{48}\) estimate that North Sea oil and gas exports, the vast majority of which originate from Scottish waters, boosted the UK’s balance of payments by £40 billion 2011-12. The de-facto contribution to the Scottish economy however needs to be seen in the context that oil is traded offshore by large international companies.

**Conclusion**

4.80 Scotland is a wealthy country. In terms of output per capita it is on a par with many other successful independent countries.

4.81 Scotland has key strengths, particularly in sectors such as food and drink, energy, life sciences and tourism. Scotland also has a world class research base, with top-ranking universities, and a global reputation for science, engineering and creativity. And despite

4 The Scottish Economy

the recent challenges, the financial sector continues to perform well, particularly in areas such as asset management, pensions and insurance.

4.82 As a location for international investment, Scotland also performs strongly. For example, the Ernst and Young Attractiveness Index\(^\text{49}\) has placed Scotland as the top UK destination for foreign direct investment in terms of job creation during the last two years.

4.83 In energy, Scotland is one of the richest nations in Europe. It is estimated that there could be up to 24 billion barrels of oil and gas remaining in the North Sea. At the same time, Scotland is estimated to have around 25% of Europe’s potential offshore wind and tidal energy, a tenth of Europe’s wave power potential, and an estimated 50% of carbon capture and storage reserves. Significant efforts are being made to capitalise on the supply side benefits of these assets – particularly in terms of high value manufacturing.

4.84 Scotland also benefits from mature and well-functioning institutions coupled with high levels of social capital and trust. It has an open, trading economy with a highly skilled and flexible labour market. The country also ranks strongly as a positive ‘place to live’, something that is increasingly important in attracting and retaining skilled workers and investment.

4.85 But the Scottish economy also faces a number of challenges, not least tackling the long-term growth gap between Scotland and other comparable countries. It is clear that over the long-term, Scotland has not completely fulfilled its economic potential.

4.86 The Working Group notes that the Scottish Government believes that there are two principal reasons for this. Firstly, the UK economy has underperformed relative to its peers. In recent decades, the UK economy became unbalanced and more indebted. Inequalities grew rather than fell, with the gap between the rich and poor becoming greater. As a result, the UK economy, and by implication Scotland, has lost ground against its competitors.

4.87 Secondly, and more fundamentally, in an increasingly competitive global economy targeted policies designed to capture the unique strengths and address the relative weaknesses of

an economy are all the more important. Under the current constitution arrangements, the full range of economic policies cannot be tailored to the specific structure, opportunities and challenges of the Scottish economy. The Working Group notes that the Scottish Government believes that this puts Scotland at a disadvantage and is also evident in the divergence in performance of the economies of other regions within the UK vis-à-vis London and the South East.
5: Macroeconomic Frameworks – Design and Principles

Chapter Summary

- This chapter provides a factual and technical introduction to the design of macroeconomic frameworks which is used as a basis for applied discussion in later chapters.

- The design of a macroeconomic framework typically revolves around three key pillars – monetary policy (including the choice of currency), financial stability and fiscal policy.

- Macroeconomic frameworks can – and should – evolve over time. At their heart however, should be a commitment to long-term stability, transparency and sustainability, and the means to provide flexibility in response to unforeseen events.

- It is now clear that the macroeconomic frameworks of many countries – including the UK – contributed to, rather than prevented, the financial crisis and subsequent recession. The failure to recognise the importance of stability and effectively address systemic risk in the financial sector, the reliance upon fiscal targets which were not credible, and the mistaken belief that a focus on inflation targeting and efficient markets alone could guarantee stability, all helped contribute to the crisis.

- In an increasingly interdependent global economy, many countries are choosing to align and/or adopt common principles and proposals in relation to key aspects of macroeconomic policy.

- Under independence, the Scottish Government would be responsible for the design and implementation of its own macroeconomic framework – one that is suited to the economic environment in Scotland.

- A number of choices would be open to Scotland for how it could organise and manage its macroeconomy post-independence. These options are discussed in Chapters 6 and 7.
Introduction

5.1 The macroeconomy of a country reflects the total economic activity of individuals, businesses, and the public sector. As such, macroeconomic outcomes – growth, inflation and employment – are the end result of multiple economic decisions, inter-linkages and events.

5.2 Macroeconomic stability is important. Significant fluctuations in output, employment and inflation lead to uncertainty and can reduce an economy’s long-term growth potential.

5.3 In contrast, stability creates an environment attractive for trade, investment, innovation and job creation. Macroeconomic stability is also vital in establishing the right incentives and opportunities for effective policy delivery.

5.4 Economies are, however, subject to continuous shocks which can lead to changes in incomes and employment over time. Macroeconomic policy has an important role in helping to smooth these fluctuations.

5.5 Broadly speaking, there are three key aspects that governments must consider to ensure macroeconomic stability:

- Monetary Policy
- Financial Stability
- Fiscal Policy

5.6 This chapter provides a factual and technical introduction to the key macroeconomic choices for Scotland. It also sets out a series of principles to help identify the key components of a successful framework.

The Macroeconomic Framework

5.7 The recent global economic crisis has highlighted the serious consequences of macroeconomic instability.
While policymakers were focussing on the positives of the so-called NICE period - i.e. the decade of non-inflationary consistent expansion (NICE) in the run up to 2008 – the same period was characterised by a build-up in both public and private indebtedness and growing systemic risks in the financial sector. The macroeconomic policy architecture of the time did not adequately monitor or combat these instabilities and imbalances.

As a result countries, such as the UK, were badly exposed to the full effects of the financial crisis and constrained in their ability to respond effectively.

In the light of this, policy makers are now actively reappraising the frameworks needed to ensure macroeconomic stability. In recognition of the growing international inter-linkages, many of these frameworks are being designed in partnership across national boundaries. These developments provide important background for the design of a macroeconomic framework for Scotland.

Objectives

As highlighted in Chapter 3, the Scottish Government has two clear overarching objectives to underpin the design of an overall economic framework for Scotland:

- **long-term competitiveness** – maximising opportunities to raise productivity, competitiveness and economic growth over the long term; and

- **short-run responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

Long-term competitiveness

A macroeconomic framework that enhances long-term competitiveness is vital in delivering an environment conducive to faster sustainable economic growth.

The Scottish Government currently has responsibility for a range of important policy levers which can support the long-term performance of the Scottish economy. These levers focus on improving the supply-side (or ‘micro’) drivers – e.g. infrastructure, education, skills and health and well-being.
5 Macroeconomic Frameworks – Design and Principles

5.14 However, these policies are set within an overall macroeconomic framework over which the Scottish Government has little influence. This includes monetary policy, financial stability, economic regulation and key aspects of fiscal policy, such as the tax environment.

5.15 Under independence, these policy areas would be the responsibility of the Scottish Parliament and Scottish Government. The choices to be made with regard to how Scotland discharged these functions vary. Many countries have chosen to coordinate key elements of their macroeconomic policy with other countries to promote trade and long-term competitiveness, but retain responsibility for other elements (particular fiscal and microeconomic policies) to target their own unique challenges and opportunities.

Short-run responsiveness

5.16 Changing preferences, technological breakthroughs, financial instability, natural disasters or global political developments can all act to change the economy, often unexpectedly and over short time periods.

5.17 Flexible and resilient economies are adept at responding and absorbing change. However, if a shock is sufficiently large, or there exists rigidities (in price, supply and investment responses), an economy may take time to adjust.

5.18 Therefore alongside ensuring that conditions are conducive for long-term competitiveness, the ability to respond flexibly to changing economic circumstances is an important element of macroeconomic policy.

5.19 Under the current constitutional framework, responsibility for macroeconomic stability rests almost entirely with the UK Government. Being part of a larger economic union can offer a degree of macroeconomic security through the pooling of risk. On the other hand, however, it limits the ability for a distinct response to best meet the key challenges faced in a particular locality or to meet local priorities.

Principles of Macroeconomic Framework Design

5.20 To deliver on these objectives, the work to design a robust macroeconomic framework has been shaped around four key themes:
• **Credibility** – the framework should deliver confidence for businesses, investors, financial markets and the people of Scotland.

• **Sustainability** – the framework should be affordable and support sustainable development – in the widest possible sense – over the medium to long-term.

• **Stability** – the framework should provide coherent and predictable macroeconomic policies.

• **Autonomy** – the framework should seek to provide the maximum degree of policy autonomy. It should also be sufficiently dynamic to evolve over time to meet changing economic conditions or preferences.

5.21 These principles in their own right are not sufficient to deliver increased levels of sustainable growth. They are, however, important pre-requisites upon which effective policies can be implemented.

**Components of a framework**

5.22 A modern macroeconomic framework encompass three key pillars:

• **Monetary Policy** – including the choice of currency, the framework for setting interest rates and money supply to promote price stability and minimise short-term volatility;

• **Financial Stability** – including the use of prudential regulation, supervision, resolution tools and deposit protection to ensure stability in the financial system; and,

• **Fiscal Policy** – including the setting of taxes, government spending and borrowing within an overarching framework of fiscal sustainability.

5.23 These three pillars – monetary policy, financial stability and fiscal policy – provide the overall policy framework and macroeconomic tools to deliver long-term competitiveness and short-run responsiveness.

5.24 The chart below illustrates some key elements of these three key pillars. Ensuring consistency between each pillars is important.
5.25 Macroeconomic frameworks evolve over time and reflect changes in policy and global economic developments. Box 5.01 provides a short history of the key frameworks adopted by the UK over the years.

**Box 5.01: Evolution of UK Macroeconomic Frameworks**

**Gold Standard**
- **1844**: Bank Charter Act provides for Sterling to be fully backed by gold.
- **1931**: Gold Standard abandoned.

**Fixed Exchange Rate: Bretton Woods**
<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949</td>
<td>UK Government devalues Sterling by 30% relative to US $.</td>
</tr>
<tr>
<td>1967</td>
<td>UK Government devalues Sterling by 14% (‘devaluation crisis’).</td>
</tr>
<tr>
<td>1971</td>
<td>Bretton-Woods System breaks down and Sterling becomes free-floating.</td>
</tr>
<tr>
<td>1976</td>
<td>High inflation and large budget deficits lead to IMF providing the UK with bailout of $3.9 billion with conditions including reductions in public spending.</td>
</tr>
<tr>
<td>1970s/1980s</td>
<td>Targeting growth in money supply in an effort to limit inflation.</td>
</tr>
<tr>
<td>1988</td>
<td>UK Government decides to shadow Sterling against the West German DM.</td>
</tr>
<tr>
<td>1990</td>
<td>UK joins European Exchange Rate Mechanism (ERM) – a semi-pegged exchange rate system, with fixed bands of +/- 2.25% around bi-lateral exchange rates in which a currency could move.</td>
</tr>
<tr>
<td>1992</td>
<td>UK withdraws from ERM after being unable to maintain exchange rate within permitted range – ‘Black Wednesday’. Government adopts a policy of inflation targeting with floating exchange rate.</td>
</tr>
</tbody>
</table>
5.26 A fundamental underpinning of any macroeconomic framework is the choice of currency and exchange rate regime.

5.27 There are a number of possible currency/exchange rate arrangements that a country can choose to adopt. These include a flexible exchange rate, fixed exchange rate (i.e. a currency pegged to another currency or basket of currencies) or monetary union (i.e. agreement with another country to share a currency).

5.28 As discussed in greater detail in Chapter 7 and supporting paper, the choice of currency/exchange rate regime essentially rests upon whether or not the benefits in terms of trade and macroeconomic stability of sharing a currency, or coordinating monetary policy to minimise exchange rate fluctuations, outweigh the benefits from having an autonomous interest rate policy. The degree of macroeconomic alignment, both cyclically and structurally, and the levels of cross-border trade and factor mobility are key considerations.

Objectives of Monetary Policy

5.29 Given the choice of currency arrangement, it is widely accepted that the principal goal of monetary policy should be to ensure stable and manageable inflation and, subject to this being delivered, help smooth the economic cycle.

5.30 This reflects the role of price stability in achieving economic stability more generally, and in providing the right conditions for sustainable growth. It also reflects the conventional wisdom that in the long-run, monetary policy can only affect ‘nominal’ variables (e.g. prices) and not ‘real’ variables (e.g. unemployment and real output). There can equally be risks from either excessive inflation or deflation.

5.31 In practice, monetary policy is delivered through careful management of the official interest rate that the central bank/government sets for a monetary area. This interest rate affects the whole range of interest rates set by commercial banks, building societies and other institutions. Monetary policy can also help with the provision of liquidity in the banking system, however the inter-bank market also plays an important role.
5.32 In certain instances however, such as in the current climate, the conventional transmission mechanisms for monetary policy can become weakened. In these instances, more unconventional tools, such as Quantitative Easing, may be needed to stimulate the economy.

Central Bank Independence

5.33 Over the past three decades, a consensus has formed around the benefits of central bank independence.

5.34 The exact nature of this independence can vary. In some cases, central banks have their independence guaranteed by statute (or constitutional amendment), while some also have the freedom to determine not just day-to-day monetary policy (e.g. the setting of interest rates and provision of liquidity) but also their remit (e.g. the numerical target for inflation).

5.35 Others, such as the Bank of England, have ‘operational independence’ with the remit/target set by the government and the central bank then given full autonomy to determine the day-to-day delivery of monetary policy to meet this objective.

Other operations of Central Banks

5.36 A central bank of a country also undertakes a number of other important tasks.

5.37 Most central banks, for example, manage a country’s reserves of foreign currency and gold. In addition, through the management of the issuing of banknotes, the central bank has a role in maintaining confidence in the currency and ensuring its proper functioning in the economy through the payments and settlements system.

5.38 These systems are vitally important to the efficient functioning of the economy. For example, they allow financial institutions to settle complex market transactions, businesses to receive payments for goods and services, and people to make purchases and receive salaries.

5.39 In many countries, the central bank of a country acts as the bank for the government. This can include managing day-to-day cash flow and ensuring that when the government needs to borrow it does so efficiently and at the best possible rate. Some countries have separate
5 Macroeconomic Frameworks – Design and Principles

debt offices which handle the explicit issuing of securities on behalf of the government. In others, this function is taken forward directly by the central bank.

5.40 Many functions of a central bank relate to financial stability including the role as the ‘bankers bank’ and in providing liquidity to the financial system. These are discussed in greater detail in the next section.

5.41 Finally, given the close linkages between the central bank, the financial sector and the wider economy, central banks – in conjunction with independent statistical offices – often collect and disseminate key financial and economic data. As part of this, central banks often act to provide independent analysis which can inform a range of actors, including the government, on developments in financial markets and the domestic and international economies.

Section 2 Financial Stability

5.42 The second key pillar of macroeconomic policy is financial stability. A well-functioning and robust financial system is a fundamental base for sustainable economic growth.

5.43 A well-developed financial system is vital to any economy however, it can be subject to market failures including moral hazard. The failure in the run-up to the recent financial crisis to properly monitor these risks (principally within banks) and to fully appreciate their systemic importance to the real economy was perhaps the greatest policy failure in decades.

5.44 In response, policy makers across the world are actively reappraising the frameworks and institutions needed to monitor and provide financial stability. A particular global challenge is the existence of large multinational financial conglomerates or groups with complex cross-border structures.

5.45 The delivery of financial stability has a number of different aspects. These include:

- Supervision and Oversight of key financial institutions and the financial system as a whole (i.e. Microprudential and Macroprudential regulation);
• A robust monetary framework (including the delivery of monetary policy as set out above) also acts to ensure the smooth operation of the market and efficient provision of liquidity; and

• Crisis Management, Resolution and Deposit Protection.

**Supervision and Oversight of financial institutions**

5.46 An important tool to promote financial stability concerns the use of policy to monitor the financial safety and soundness of key institutions and the system as a whole.

5.47 Supervision and oversight designed to ensure stability in institutions themselves is commonly referred to as *microprudential regulation*. This is particularly important for institutions (primarily banks and insurance companies) whose scale, or importance to key aspects of the financial system, cause them to pose a systemic risk to the wider financial sector and the real economy.

5.48 Policy levers include monitoring institutions’ balance sheets, capital ratios and business models. It can also include more fundamental and basic issues, such as the certification of key people working in the financial sector.

5.49 A growing aspect of such oversight and regulation is the establishment of core conditions to be met by banks and major financial institutions. The Basel III capital adequacy rules for example, which will apply to banks irrespective of where they are based and to be phased in by 2019, aim to increase both the stock and quality of permanent bank capital in an effort to improve resilience to future shocks.

5.50 Whilst microprudential regulation concerns itself with the stability of individual – and systemically important – financial institutions, macroprudential regulation focuses on the stability of the financial system as a whole (or in key parts of the financial system). It examines both trends across financial institutions collectively, and also within the wider economy (for example, the emergence of asset price bubbles).
5 Macroeconomic Frameworks – Design and Principles

5.51 This is largely a new area for policymakers and detailed proposals on how such regulation will work in practice continue to be developed.\(^{50}\)

5.52 The basic idea however, is to identify, monitor and remove systemic risks within the financial system. By doing so it aims to address a fundamental weakness of previous macroeconomic frameworks where, with monetary policy focussed on price stability, fiscal policy targeted toward boosting growth and meeting deficit targets, and financial regulation focussed solely on individual firms or products, economy-wide (or ‘collective’) financial risks were not effectively or adequately considered.

5.53 In addition, an increasing number of economists believe that macroprudential policy can be used not just to mitigate financial sector risk, but also to help determine the stance of macroeconomic policy overall. For example, counter-cyclical flexible capital ratios can be used to help encourage banks to lend (or rein in lending if there were concerns over unbalanced growth in asset prices) and/or flexible loan-to-value ratios can be set for mortgage lending to help influence house price inflation to some extent.

5.54 These supervisory and oversight functions provide mechanisms to prevent some market failures arising. However, ensuring that there is an effectively functioning market is also a key factor in maintaining financial stability.

Monetary Market Framework and Liquidity

5.55 The above aspects of financial stability policy are designed to protect against unexpected risks to individual financial institutions and minimise risks building up in the overall financial system and wider economy.

5.56 In theory markets – in the absence of market failures - should be able to ensure financial stability. For example, financial institutions would hold enough liquid assets to insure against any adverse shocks and, if needed, be able to trade with other institutions in the

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\(^{50}\) For a definition and overview of macro-prudential policy developments see: Macro-prudential Policy Tools and Frameworks – an update to G20 finance ministers and central bank governors, IMF, BIS & FSB, Feb 2011, [http://www.bis.org/publ/othp13.pdf](http://www.bis.org/publ/othp13.pdf)
event of any shortfall. An efficiently functioning inter-bank market is essential to facilitate this process\textsuperscript{51}.

5.57 The inter-bank money market is the market in which banks borrow and lend short-term funds between each other. It is central to the entire financial system. In circumstances where there are limited uncertainties in financial markets it is the main source of short-term liquid funds for financial institutions. However, when the inter-bank market fails to allocate resources efficiently it can threaten financial stability through its effect on liquidity and credit availability.

5.58 Unfortunately, financial stability has many of the characteristics of a public good and therefore key aspects of an efficient system such as liquidity may not always be provided at an optimal level.

5.59 Confidence in the liquidity of individual banks and the banking system as a whole is central to financial stability. However, instability can happen from time to time, even with the best supervisory and monitoring structures in place. An aspect of ensuring financial stability is therefore to have in place an effective money market framework to provide such liquidity if needed.

5.60 When adverse shocks impact on financial stability, a number of tools can be used (see Box 5.03). In the main, most financial crises are matters of liquidity. These can be handled by the central bank through its role as the ultimate provider of liquidity or as ‘lender of last resort’ (See Box 5.02).

5.61 In most cases central bank liquidity operations and lender of last resort functions are accessible to all eligible and authorised financial institutions in a country, regardless of the location of the institution’s headquarters. In addition, central banks typically offer short term ‘swap lines’ to each other to support liquidity internationally.

Box 5.02: Lender of Last Resort

‘Lender of Last Resort’ is a commonly used term but as a concept it is quite often also misunderstood.

The term ‘Lender of Last Resort’ (LoLR) refers to the safety net that a central bank extends to a solvent financial institution operating in their jurisdiction when it cannot obtain finance from market sources. It can also refer to the role that a central bank has in the provision of market-wide liquidity.

Given that financial instability and liquidity crises can impact on markets and financial institutions in a number of ways, there are different types of intervention and thus varying interpretations of what LoLR actually means.

The following examples provide an illustration of different types of LoLR intervention:

- It can refer to the response to a general market wide shock leading to a widespread liquidity shortage. This is often dealt with as part of a central bank’s published framework for intervention in money markets – including facilities such as open market operations (OMO’s) and operational standing facilities (OSF’s).

- However, it can also refer to specific collateralised loans to an illiquid – but solvent – financial institution in response to a company specific request. In these situations the central bank may have to intervene beyond its published framework. This can be done on a bilateral basis with individual institutions (i.e. Emergency Liquidity Assistance).

As a result of the financial crisis, many central banks have revised their frameworks to better deal with different liquidity crises and to respond more quickly. There is now greater flexibility with a wider range of policy options. As such it should reduce the need for interventions beyond central bank’s published frameworks in the future. It should be noted that to avoid Moral Hazard, liquidity is provided at a cost to commercial banks, therefore central banks can often make substantial profits from these interventions.

When LoLR functions are referred to in this report, it is the above provision of liquidity that is being described and not the wider response to crisis management in the financial sector, which includes many other tools such as effective resolution and deposit protection (see Box 5.03).

Another factor that is often confused with the term Lender of Last Resort, is the concept that a central bank acts as the Lender of Last Resort to a country’s government (i.e. printing money to avoid government default on debt). Modern central banks do not or should not do this, given the inflationary implications such actions would have.
5.62 Generally Lender of Last Resort interventions involve the provision of liquidity to solvent but illiquid banks, which therefore involves limited risk to the central bank. Any lending to a bank that is potentially insolvent could expose the central bank to potential losses. Therefore many central banks require the fiscal authority to indemnify the central bank exposure when there is a degree of uncertainty.

5.63 In practice, if an institution was insolvent the government would need to make a policy decision on whether or not to intervene and provide capital to prevent its failure. In such a scenario, the central bank may advise on the systemic consequences of the failure of the institution. The principles that underpin crisis management interventions in such a scenario are discussed below.

Crisis Management and Resolution

5.64 In most cases, financial crises are matters of liquidity. However, on rare occasions they can extend to matters of solvency. In such a scenario, provision of liquidity will be insufficient.

5.65 In circumstances where there is a risk of potential insolvency which requires resolution to be managed and resolved, this requires coordination between financial regulators, the central bank and primarily one or more fiscal authorities. Ultimately, and contrary to the common conception, it is not a central bank that ‘bails-out’ banks in the sense of providing direct cash injections, but fiscal authorities (i.e. governments).

5.66 Alongside the immediate containment of a crisis, robust approaches are required to manage institutional failures and prevent a wider loss of confidence in the financial system.

5.67 It is widely accepted that this should be carried out in an orderly way so as to limit the impact on the real economy (and taxpayers), whilst also reducing Moral Hazard. In order to protect retail depositors, countries also have in place some form of deposit insurance scheme(s). Such funds primarily cover deposits in banks up to a pre-specified limit, but can also extend to insurance policies and some other financial products. In the event of an insolvency, such funds ensure that depositors savings are protected and any disruption to their access to banking services is minimised.

5.68 As highlighted above, financial firms increasingly operate across national boundaries. This creates a need to coordinate supervision and oversight activities as well as crisis
management and resolution on an international basis due to the public good nature of the stability that ensues from such policies. Without coordinated international monitoring, cross border risks may not be identified adequately. Unfortunately, supervision and crisis management tools have failed to keep up with the trend toward cross-border financial institutions. This posed a challenge for a number of countries during the recent crisis.

5.69 This is therefore an active area of reform and research – see for example the emerging proposals around an EU Banking Union. Some commentators have suggested an approach that explicitly sets out options for burden sharing to reflect the cross-border nature of the benefits from effective resolution and to avoid free-riding.\(^{52}\)

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**Box 5.03: Actions to manage financial crises**

**Liquidity Support**

Financial institutions can and should protect themselves against liquidity shocks by holding adequate liquid assets. Liquidity ratios are an integral part of the conditions financial institutions must meet under Basel III. In most cases, the market should provide a mechanism to access these liquid assets.

It is in the public interest however, that central banks should provide a degree of additional insurance in order to avoid liquidity crises for banks that are otherwise solvent and viable. This should be underpinned by effective supervision and oversight as outlined in the previous section.

The provision of liquidity is valuable for financial institutions, but need not be costly for the taxpayer as long as they cover their borrowings from the central bank with sufficient levels of high quality collateral. Institutions which do not have adequate collateral or are deemed insolvent can be dealt with through other channels, including via appropriate resolution mechanisms (see below).

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\(^{52}\) Living Wills as a Catalyst for Action, DSF Policy Paper No. 4, Avgouleas, E, Goodhart, C and Schoenmaker, D, May 2010
| Resolution | In the event of the failure of a financial institution which has systemic importance, swift and quick resolution is required.  
Options for resolution can take a number of forms, such as transfer of ownership to a private sector purchaser, temporary transfer to a holding bank (e.g. the central bank), public ownership (e.g. government), or ultimately insolvency or administration processes.  
These actions can relate to the entire company or particular elements of the business.  
In certain cases, the fiscal authority (or fiscal authorities) could provide a direct capital injection into a commercial financial institution (bail out). This can be temporary – to help manage short-term crisis – or longer term. In this case, the government becomes an explicit shareholder.  
Alternatively, another tool that can be used is imposing losses on shareholders and unsecured creditors (bail-in approach). |
| Deposit Guarantee Scheme | In order to protect consumers, most governments offer protection to customers through deposit guarantee schemes.  
This also ensures confidence in the financial system during periods of uncertainty or crisis and helps prevent any further escalation of a financial crisis (e.g. to help avoid a ‘bank-run’).  
There are a number of approaches to the design and funding of such schemes, although most are based upon industry funded models.  
During a financial crisis however, a fiscal authority can act to extend the scope of a guarantee or to provide loans to a scheme when immediate funds are required. |
Section 3: Fiscal Policy

5.70 A key element of a well-functioning macroeconomy is a credible and flexible fiscal framework which supports monetary policy and financial policy in delivering macroeconomic stability.

5.71 Both monetary policy and financial stability can be seen as providing the stable foundations for prosperity. Fiscal policy on the other hand has the added dimension of using the specific levers of the tax system and public spending to target key challenges that a country faces and/or seek to take advantage of new opportunities.

5.72 Fiscal policy decisions imply choices about economic and social objectives, such as the distribution of income and wealth across society and the provision of public goods.

5.73 Governing these choices however, should be a stable tax and public spending framework which promotes economic growth. This is important for investment and confidence.

5.74 Fiscal frameworks require careful management of public sector deficits and debt. A transparent framework which delivers market confidence can also ensure that a government’s borrowing costs are minimised.

5.75 The recent challenges in the Euro Area highlight the importance of fiscal responsibility and a full assessment of the possible contingent liabilities of the public sector. The design of a robust fiscal framework is challenging however, and countries have adopted a range of solutions.
Box 5.04: Public Sector Borrowing

A key element of macroeconomic policy is the management of government borrowing and debt. Both are vital tools in promoting short-term stability and facilitating long-term economic growth.

Borrowing costs vary between countries. This is illustrated in Table 5.01 which shows the nominal yields on 10 year government bonds for a selection of countries.

<table>
<thead>
<tr>
<th>Table 5.01: 2013 Selected current Government 10-year Bond Yields</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>United Kingdom</strong></td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>Taiwan</td>
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<tr>
<td>Singapore</td>
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<tr>
<td>Germany</td>
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<tr>
<td>Denmark</td>
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<td>Netherlands</td>
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<tr>
<td>Finland</td>
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<tr>
<td>Sweden</td>
</tr>
<tr>
<td>Austria</td>
</tr>
<tr>
<td>United States</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream – Yields shown are for benchmark 10 year government bonds as at 25 January 2013

Total borrowing costs reflect the interest rate paid across the stock of outstanding debt. The higher the total borrowing costs, the more government revenues have to be spent on interest payments, and therefore the less is available for general expenditure.

For example, net debt payments in the UK have nearly doubled since the start of the financial crises as the stock of debt has increased, and now account for 6% total public spending.53

Financial markets judge credit risk. Governments pay different rates of interest depending upon their perceived fiscal sustainability and risk of default (either explicit or implicit).

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This is captured, to some extent, by Credit Ratings Agencies\(^\text{54}\). Credit ratings are used by investors, investment banks, brokers, regulators and governments as an easy to use measurement of the relative credit-risk of different debt instruments.

Credit Ratings Agencies use a whole host of indicators when assessing a sovereign’s credit rating. For example, Fitch principally use four key categories: growth, inflation, external balance and unemployment.

Standard indicators include:

- the fiscal balance and the growth of monetary aggregates;
- the growth and the level of living standards;
- the distribution of income.

Agencies also assess the long-run growth rate of the economy using factors such as:

- the growth rate of the population;
- the age distribution of the population;
- differences in productivity levels between different sectors of the economy.

For many of these measures, an independent Scotland could expect a broadly similar score to the UK, though it would be important to demonstrate credibility.

5.76 Public sector borrowing and net debt are two of the most important and valuable tools of macroeconomic policy open to governments.

5.77 In addition to assisting with day-to-day cash flow management, the opportunity to borrow can provide an important stabilisation mechanism when tax receipts fall and expenditures rise unexpectedly. It can also be used as a mechanism to fund large scale infrastructure projects.

5.78 However, as with any issuing of debt, it must be managed carefully to ensure affordability and sustainability.

\(^{54}\text{There are three main credit ratings agencies – Moody’s, Standard and Poor’s, Fitch. Each adopts their own methodology for assessing credit risk. Assessments are based on a range of quantitative and qualitative factors reflecting political, economic, financial and social issues}\)
5.79 Two key approaches have been adopted by countries to help manage their public finances:

- Fiscal Rules;
- Fiscal Commissions.

**Fiscal Rules**

5.80 One way to provide structure to a fiscal framework is to design ‘fiscal rules’ which set out the general parameters for managing the public finances, such as limits on the amount that can be borrowed or the total stock of debt.

5.81 These rules typically relate to the overall stance of fiscal policy (i.e. debt and deficits) rather than particular tax and spending elements.

5.82 The use of fiscal rules has increased in recent years. The IMF estimate that in 1990, only five countries had fiscal rules; however by March 2012 this number had grown to 76\(^{55}\).

5.83 Fiscal rules can be useful if there is a concern of an inherent bias in favour of deficits or if a country/government is seeking to establish a reputation for fiscal responsibility. They are also important within the context of a monetary union as a mechanism to guard against the profligate actions of one country imposing costs (e.g. credit risk and/or inflation) on their partners within the union.

5.84 Options include:

- Budget balance rules covering the aggregate net fiscal position, or the structural/cyclically adjusted deficit. Most refer to a particular time period e.g. “over the cycle”;
- Targets aimed at debt sustainability. They are often set as an explicit limit or target for public sector net debt as a proportion of GDP;
- Expenditure rules which generally set limits on the growth of (current) expenditure over a period; and,

5 Macroeconomic Frameworks – Design and Principles

- Revenue rules which typically relate to any ‘windfall’ tax receipts or commodity revenues.

5.85 For rules to be credible, it is recognised that they must also offer some flexibility in the event of unpredictable events. It is advantageous to have clearly defined ‘escape clauses’ which set out the circumstances under which this flexibility will operate. This avoids charges of manipulation of the rules.

**Chart 5.01: Fiscal Rules in Use, 2012**

<table>
<thead>
<tr>
<th>Total Rules (National and Supranational)</th>
<th>National Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>20</td>
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<td>60</td>
<td>60</td>
</tr>
<tr>
<td>70</td>
<td>70</td>
</tr>
</tbody>
</table>

Revenue Rule | Expenditure Rule | Budget Balance Rule | Debt Rule


5.86 Establishing fiscal rules does not guarantee effective fiscal management. The manner in which the rules are implemented is crucial and they also require political commitment.

5.87 Experience has shown that rules are generally most effective when there are effective discipline devices in place and when there are transparent mechanisms to monitor compliance. The lack of independent oversight is one of the reasons why the previous UK Government’s fiscal rules were seen to lack credibility.
Box 5.05: Fiscal Rules in Europe\textsuperscript{56}

**European Fiscal Compact**: The Fiscal Compact was signed by all EU members except the UK and Czech Republic in March 2012. It places limits on both the structural deficits that governments can run and the ratio of public sector debt to GDP.

**Denmark**: The Danish government has in place a number of fiscal rules including the aim of a structural budget balance in 2020. In addition, it aims to improve the structural balance by 1.5% from 2011 to 2013.

**Finland**: The Finish Government has applied a spending cap to about 80% of its expenditure. For the parliamentary term 2012-2015, spending limits have been set at 2012 prices. From 2012, the Finnish Government has committed to undertake further adjustment measures if indications are that the central government debt-to-GDP ratio is not shrinking.

**Sweden**: Since 2007 the Swedish Government has had a target of achieving a budget surplus worth 1% of GDP over the course of the business cycle.

**UK**: The UK Government has two fiscal rules. Firstly, there is a forward looking fiscal mandate which requires that policy be consistent with achieving a cyclically adjusted (or structural) current budget balance at the end of the five year rolling forecast period. Secondly, there is a supplementary target which requires public sector net debt to be declining as a share of GDP by a fixed date of 2015/16.

**Norway**: The focus of Norway’s fiscal policy is on ensuring that the country’s oil wealth provides a long term benefit for the economy. Their fiscal rules state that the use of petroleum revenues, as measured by the structural non-oil budget deficit, should over time be in line with the expected real return on the Government Pension Fund Global (GPFG), estimated at 4% of the fund’s return\textsuperscript{57}.

\textsuperscript{56} The Fiscal Rules for EU member states (UK, Denmark, Finland and Sweden) are taken from the EU Fiscal Rules Database available at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm

Fiscal Commissions

5.88 ‘Fiscal Commissions’ (sometimes referred to as ‘Fiscal Councils’) have become popular in many countries.

5.89 Fiscal Commissions are institutions typically funded by, but independent of, government, which provide non-partisan advice on fiscal issues and guidance on the overall management of the public finances. Some institutions also provide more detailed analysis of particular policy initiatives – e.g. verifying the estimated financial costs of particular policy proposals.

5.90 The motivation is similar to that for fiscal rules, in that such Commissions are believed to provide effective constraints on policymakers running unsustainable deficits. They are also believed to better prepare countries for ‘economic shocks’ and can help keep the focus on long-term time horizons rather than the electoral cycle. However, clearly democratic accountability is vital and a number of countries have approached this in different ways.

5.91 Such institutions can also provide independent oversight of the forecasts which underpin the public finances. For example, in the UK a key objective of the Office for Budget Responsibility has been to take responsibility for providing the official forecasts for growth and key fiscal variables independent of government in an effort to boost credibility.

5.92 In recent years, Fiscal Commissions have been established in a number of countries including Ireland, Portugal, UK, Australia and Sweden. They have a longer history in other countries including Denmark and the Netherlands.

5.93 A summary of the remit of Fiscal Commissions in different countries is provided in Box 5.06.

5.94 Fiscal Commissions offer a number of potential advantages.

5.95 By providing independent oversight they can improve the credibility of the macroeconomic framework and give confidence to markets. They can also reduce the incentive for governments to plan their fiscal policy on the basis of overly optimistic forecasts. Their expert advice can help improve the policy development process, whilst leaving the final decisions to elected representatives.
Box 5.06: International Examples of Fiscal Commissions

**Denmark:** The Economic Council, established in 1962, prepares economic reports and forecasts on a range of issues including fiscal policy.

**Netherlands:** The Netherlands’ Central Planning Bureau (CPB) contributes to the design, implementation and evaluation of budgetary plans. It has a wide remit which includes the provision of independent macroeconomic and budgetary forecasts and analysis of policy.\(^{58}\)

**Ireland:** The Irish Fiscal Advisory Council\(^{59}\) was established in 2011. It independently assesses the Government’s macroeconomic and budgetary projections. It also assesses the progress of the Government in meeting its budgetary objectives and compliance with fiscal rules.

**Sweden:** The Swedish Fiscal Council evaluates the transparency of the budget, the quality of the government’s forecasts and the models used to generate these forecasts.

**UK:** The Office for Budget Responsibility (OBR) produces forecasts for the economy and public finances and judges progress towards the Government’s fiscal targets. It also assesses the long-term sustainability of the public finances and scrutinises the costing of Budget measures.

**United States:** The United States Congressional Budget Office (CBO) is mandated to provide objective and non-partisan analyses to aid economic and budgetary decisions.

5.96 In increasing the provision of information, they can also help inform the public debate. The level of information provided by the OBR is, for example, much more detailed than was ever produced by HM Treasury.

5.97 Fiscal Commissions can also increase the effectiveness of fiscal rules. For example, many fiscal rules are set with reference to the economic cycle and any assessment on performance is open to subjective judgement. Delegating responsibility for assessing performance against such rules to a Fiscal Commission, while not guaranteeing the accuracy of the assessment, at least ensures it will be independent and credible.

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\(^{59}\) [http://www.fiscalcouncil.ie/](http://www.fiscalcouncil.ie/)
Fiscal Policy in Monetary Union

5.98 In the light of the crisis in the Euro Area there has been a reappraisal of the role of fiscal policy within a monetary union, and in particular, the importance of designing robust structures to ensure sustainability.

5.99 A common requirement for countries in a monetary union is an agreement over the overall fiscal position of each member (i.e. net debt and borrowing). This is to ensure that the fiscal position of one member state does not destabilise the monetary union or lead to higher inflation. This requires strong and robust application of rules.

5.100 Limitations on borrowing and deficits are typically at the composite level, and still allow for flexibilities in the design of the underlying tax system and a range of specific policies suitable for each Member State. Indeed, such flexibility is vital to the success of a monetary union as it provides the autonomy and policy levers to target country specific differences (advantages and weaknesses) which cannot be tackled with a common monetary policy. This should help ensure alignment in terms of economic performance. It is also vital for democratic accountability and legitimacy.

Conclusions

5.101 There are various facets to the design of macroeconomic frameworks and a number of positive choices to be made.

5.102 In practice, countries have adopted a variety of different approaches to manage monetary policy, financial stability and fiscal policy.

5.103 However, countries are – particularly in the areas of monetary policy and financial stability – choosing in their own interest to align and coordinate their macroeconomic frameworks. This provides a basis for greater macroeconomic stability which can then be managed at the margin to the conditions of their own local area. This presents important lessons and opportunities for an independent Scotland.
6: The Current Framework

Chapter Summary

- Chapter 6 builds on the theoretical summary in Chapter 5 by providing an overview of the current macroeconomic framework in the UK.

- Scotland’s current economic framework is defined by the Scotland Act 1998 and the new additional economic and fiscal responsibilities contained within the Scotland Act 2012.

- Under the current framework, monetary policy, financial regulation and key elements of industrial policy and economic regulation are reserved to the UK Government.

- This chapter outlines the current frameworks and institutional arrangements in place for monetary policy and financial stability in the UK.

- The Scottish Government has no distinct input into these areas from a macroeconomic perspective, and there is no form of accountability to the Scottish Parliament.

- The overarching fiscal framework is also reserved to the UK Government. This not only includes the overall fiscal stance, but the framework in which spending is allocated to Scotland.

- In its current form (including powers introduced by the Scotland Act 2012) the fiscal framework offers a much higher level of spending autonomy than revenue autonomy (58% vs. 16%).

- In the main, the Barnett formula currently determines how much spending is allocated to Scotland, based upon comparable spending choices in Whitehall departments. The UK Government could choose to introduce a new funding system – and either cut or increase the block grant to Scotland – without any consultation or consideration of the views of the Scottish Parliament.

- The Scottish Government has full autonomy within its spending priorities, in areas such as Health, Education and Transport. It has no input into other areas of spending such aspects of Welfare.

- The Scotland Act 2012 increases Scotland’s tax powers to 16% of tax revenues. The Scottish Government will also gain limited capital borrowing powers.
6 The Current Framework

Introduction

6.1 This chapter describes Scotland’s current macroeconomic framework based on the current UK framework, the Scotland Act 1998, and the forthcoming reforms contained in the Scotland Act 2012.

Monetary Policy

6.2 Monetary policy is fully reserved and conducted by the Bank of England. The Bank of England sets interest rates, conducts open market operations in money markets and manages the UK’s foreign exchange reserves. It does so on behalf of the entire UK.

6.3 The monetary policy remit of the Bank of England is to deliver price stability, as defined by an inflation target of 2%, measured by the Consumer Prices Index (CPI)\(^{60}\).

6.4 The target is set for the collective UK economy and does not allow for differential prices or cycles within the UK. However, the monetary policy framework does take into account the performance of the different constituent parts of the UK to the extent that they influence the overall economy. Observation of spatial aspects in the performance of the UK economy is provided by the Bank of England’s network of Regional Agents.

6.5 The Bank of England is operationally independent\(^{61}\). In effect, this means that while the day-to-day operation of monetary policy to meet the inflation target is devolved to the Bank, the UK Government is responsible for setting the remit of the Bank, including the objectives and priorities of monetary policy. Box 6.01 provides a summary of the Bank of England’s current governance structure and functions.

6.6 The fact that the Chancellor sets the objectives for the Bank, and has oversight of key appointments, means that the nature of central bank independence in the UK is different from some other countries. The exact design of central bank independence is an on-going area of debate, particularly the design of objectives for the central bank in times of economic stress.

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\(^{60}\) [http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx](http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx)

\(^{61}\) The Bank of England was made independent in 1997
6.7 Under the current framework, the Bank of England is only directly accountable to the UK Parliament.

Box 6.01: The Bank of England

The Bank of England, founded in 1694, is the central bank of the UK and is owned by the UK Government.

The Bank has two core purposes; **Monetary Stability** and **Financial Stability**.

Its key responsibilities include –

- Setting the UK’s official interest rate;
- Monitoring and maintaining financial stability;
- Issuing banknotes;
- Offering lending and deposit facilities to banks in the UK;
- Overseeing the operation of inter-bank payment systems; and,
- Managing the government’s foreign currency and gold reserves.

**Governance**

**The Court** is responsible for all aspects of the Bank’s operations except monetary policy. The Court delegates day-to-day operations to the Governor but reserves the right to agree to the Bank’s strategy and objectives.

**The Governor** is appointed by the Crown and has a wide range of responsibilities. The Governor chairs the Monetary Policy Committee, the Financial Policy Committee and will also chair the Board of the Prudential Regulatory Authority.

- The **Monetary Policy Committee** determines monetary policy. Membership comprises senior Bank Executives and four independent external members. A non-voting representative from HM Treasury also sits on the MPC.
- The recently established **Financial Policy Committee** aims to promote resilience in the financial system and to remove and reduce systemic risks.
- The **Prudential Regulatory Authority** is being set up to promote the safety and soundness of regulated firms.
6 The Current Framework

Treatment of Profits

The Bank has monopoly rights in the issue of currency and monetary policy and is the key player in financial stability. As is the case with other central banks, in carrying out these functions it typically generates substantial profits. The most profitable functions are the issue of currency and the holding of commercial banks’ reserves (i.e. seigniorage profits).

The Bank splits its activities into a ‘Banking department’ and an ‘Issue department’. The net profit of the Issue department is transferred to HM Treasury. Profits from the ‘Banking department’ are shared between the Bank and HM Treasury.

### Bank of England Profits by Department

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue</td>
<td>£2,327m</td>
<td>£2,188m</td>
<td>£491m</td>
<td>£475m</td>
<td>£851m</td>
</tr>
<tr>
<td>Banking</td>
<td>£161m</td>
<td>£833m</td>
<td>£194m</td>
<td>£127m</td>
<td>£72m</td>
</tr>
</tbody>
</table>

Issue – Profits associated with note issue up to the end of February, transferred in full to HM Treasury
Banking – Annual post-tax profit earned in the course of banking activities up to end of February
Source: Bank of England

Financial Stability

6.8 Measures to ensure financial stability and regulation of financial markets are also fully reserved. The current arrangements are set out below.

Supervision and oversight

6.9 The UK financial regulatory framework is currently being reformed. As part of the new framework the Bank of England retains overarching responsibility for financial stability, however it will now have far greater powers to carry out this task effectively.

6.10 This includes the establishment of a Financial Policy Committee to identify, monitor and take action to remove or reduce system risks with a view to protecting and enhancing the
resilience of the UK financial system\(^{62}\) (i.e. macroprudential regulation) and a Prudential Regulatory Authority to take forward significant microprudential regulation.

6.11 The UK Government has outlined changes to the current regulatory framework in the Financial Services Act 2012\(^ {63}\). Details of the new emerging architecture for financial regulation in the UK are summarised in Box 6.02.

**Box 6.02: The new UK financial regulatory framework**

**The Financial Policy Committee (FPC)**

- Responsible for macroprudential regulation.
- A sub-committee of the court of directors of the Bank of England which has powers of direction and recommendation to the regulatory authorities - PRA and FCA.
- Has a range of macroprudential tools at its disposal such as setting capital ratios. Possible tools include counter-cyclical capital buffers and powers of direction over sectoral capital requirements\(^ {64}\).

**The Prudential Regulation Authority (PRA)**

- Responsible, along with the FCA, for authorisation of significant UK based deposit takers and insurance companies.
- Responsible for regulatory oversight of deposit-takers, insurers and major investment firms. Will monitor threats to the safety and soundness of financial firms\(^ {65}\).
- Focus will be on financial institutions which pose a systemic risk should they encounter difficulty.
- Will have responsibilities to work with other parts of the Bank of England as part of the implementation of the Special Resolution Regime (see later in chapter).

\(^{62}\) http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx

\(^{63}\) http://www.publications.parliament.uk/pa/bills/lbill/2012-2013/0025/2013025.pdf


6 The Current Framework

The Financial Conduct Authority (FCA)

- Focus on how financial firms conduct their operations with other firms and business & retail customers.
- Will cover issues such as mis-selling of financial products, money laundering and financial crime.
- The FCA will cover approximately 27,000 firms, including those under the prudential oversight of the PRA.

Monetary framework and liquidity

6.12 Prior to the onset of the financial crisis, the Bank of England’s Sterling Monetary Framework ensured that short-term money market interest rates - in the inter-bank market - were generally close to the official ‘Bank Rate’. This meant that the monetary policy transmission mechanism operated effectively and that there was a vehicle for commercial banks to access short-term liquid assets via the market.

6.13 However, as a result of the financial crisis, which first started in late 2007, the effective operation of the inter-bank market became limited due to market concerns about certain financial institutions’ solvency and liquidity and the stability of the entire system. In response, the Bank of England had to adapt its operations to provide greater day-to-day liquidity support.

6.14 In response to these experiences, there have been a number of developments in the Bank of England’s framework for financial stability in the money markets. The Bank of England 2010 Red Book sets an objective for the Bank’s operations in the Sterling money markets to: “reduce the cost of disruption to the liquidity and payment services supplied by banks to the UK economy”. The Bank of England does this by balancing the provision of liquidity insurance against the costs of creating incentives for commercial banks and building societies to take greater risks.

6.15 A brief explanation of these functions is set out in Box 6.03


Box 6.03: UK Money Market Framework

There are a number of ways in which the Sterling Monetary Framework provides liquidity insurance, with each facility providing different functions. Some facilities are primarily intended to implement monetary policy. Others are more specifically designed to provide liquidity.

- **Reserves** - banks are able to manage liquidity by varying their reserves balances with the central bank both intra-day and day-to-day.

- **Open Market Operations (OMO)** – OMO’s are principally related to monetary policy implementation, they allow individual banks to bid for reserves on a regular basis.

- **Operational Standing Facilities (OSF)** – provide a short-term lending facility allowing banks to borrow reserves against high-quality collateral, while the deposit facility allows banks to place excess reserves with the Bank. 68

- As a response to the financial crisis the Bank of England also introduced additional facilities allowing banks to borrow against a wider set of collateral or over a longer time period. 69

- **The Discount Window Facility** was created to provide a facility for bilateral liquidity insurance, providing gilts against the widest collateral set.

In certain circumstances the Bank of England may also engage in **Emergency Liquidity Assistance (ELA)** – this is a liquidity support operation that is outside the Bank of England’s published framework and the terms around ELA are not established in advance. This typically refers to short-term provision of central bank reserves/treasury bills in exchange for illiquid assets.

The aim of these interventions is to provide a robust framework for the Bank’s role as Lender of Last Resort. In summary -

- The Bank of England has freedom to act within the terms of a published framework which offers liquidity insurance to the financial system;

- Any ELA to firms at risk but judged to be solvent must be authorised by the Chancellor and HM Treasury.

The Chancellor also has the power to direct the Bank to conduct special support operations for the financial system as a whole, or to provide ELA. Any operation conducted under such an instruction is also likely to be indemnified by government.

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68 Currently, the rate on the deposit facility is set at zero, so there is no incentive for any reserves account holder to use the deposit facility. The rate is normally 25bps below Bank Rate, but was reduced to zero when reserves averaging was suspended

69 These include Indexed Long-Term Repos (ILTR) and Extended Collateral Term Repos (ECTR)
6 The Current Framework

6.16 Banks do not have to be headquartered in the UK to receive liquidity support from the Bank of England. Likewise, financial institutions headquartered in the UK can access liquidity facilities from central banks in other jurisdictions that they may operate within. The eligibility criteria for banks operating in the UK to receive different types of liquidity support are set by the Bank of England.70 The overall objective is the stability of the system as a whole – taking into account any potential knock-on effects for other financial institutions and the likely costs and risks to the central bank.

6.17 One of the key points to recognise with regard to the provision of liquidity insurance is that as a result of the financial crisis, the Bank of England’s Sterling Monetary Framework has become much wider in its coverage. Many of the interventions that would previously have required some form of ad-hoc Emergency Liquidity Assistance (ELA) can now be addressed via the Bank’s published framework.

“The Bank’s lender of last resort (LoLR) function has been fundamentally transformed since 2008. In terms of providing liquidity support, a large part of what in the past was termed ELA has now been institutionalised in facilities within the Bank’s published framework...there is now a much reduced space in which ELA might need to be contemplated.”71

6.18 These reforms have greatly increased the ability of the Bank of England to provide effective liquidity insurance for the financial sector.

Indemnities for the Provision of Liquidity

6.19 The Bank of England’s Emergency Liquidity Assistance (ELA) in 2008 was a clear example of a lender of last resort (LoLR) function.

6.20 As part of its role in providing liquidity to the financial system, the Bank of England sought to minimise risks to its balance sheet by acting prudently and taking account of moral hazard (i.e. by accepting significant collateral at a discounted price).

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As set out in Box 6.04 some interventions were underpinned by an indemnity from HM Treasury. However, the Bank’s 2008 ELA operations were not fully indemnified. Overall, taking account of the direct ELA funds provided to two commercial banks (RBS and HBOS) and all other ELA facilities, the Bank of England was indemnified for 12% of its exposure.\textsuperscript{72}

The Bank was repaid in full by the commercial banks by January 2009. The Bank suffered no loss and the operation generated a return of around £175 million.\textsuperscript{73}

**Crisis Management, Resolution and Deposit Protection**

The reforms to the monetary framework and liquidity provision, alongside the changes to supervision and oversight aim to reduce the probability and scale of future crises and allow for earlier interventions. However, effective mechanisms need to be in place to manage crises if they do occur.

As highlighted in Chapter 5, most crises are matters of liquidity. On rare occasions they can spill-over into wider issues of solvency. In these situations, liquidity interventions may not be sufficient or appropriate to manage potential wider risks to financial stability.

As a result, there have also been a number of key developments in better defining the roles of the Bank of England, HM Treasury and the regulators in relation to a new set of procedures to handle future crises and resolution.

As part of the Banking Act 2009,\textsuperscript{74} the Bank of England is now responsible for the operation of the Special Resolution Regime (SRR). This includes the decision on which resolution tools to use, and their implementation (with the exception of the power to take an institution into temporary public ownership) in the event that the solvency of a systemically important institution comes into consideration.

The SRR powers allow the authorities to:

- Transfer all or part of a bank’s business to a private sector purchaser;

\textsuperscript{72} Ian Plenderleith, Op cit, para 219

\textsuperscript{73} Ian Plenderleith, Op cit, para 278

6 The Current Framework

- Transfer all or part of a bank’s property to a bridge bank – a subsidiary of the Bank of England – pending a future sale;
- Recommend placing a bank into temporary public ownership;
- Apply to put a bank into a 'Bank Insolvency Procedure' while providing support to customers through the Financial Services Compensation Scheme or providing an opportunity to transfer accounts to another bank;
- Apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that is put into administration.

6.28 The SRR is designed to minimise the need for public funds. The next chapter includes discussion of international moves towards introducing the power to ‘bail-in’ in the event of a resolution to ensure that shareholders are the first to take losses prior to any public intervention or ‘bail-out’.

6.29 Alongside these mechanisms for crisis management and resolution, the UK has in place the Financial Services Compensation Scheme (FSCS) which provides protection on a number of financial products such as bank deposits, certain investments, home finance and insurance policies (which include pensions, life insurance, home and motor insurance) up to certain limits. The UK FSCS gathers revenue through an levy on the financial industry itself which is collected as needed from approximately 16,000 firms. During the recent financial crisis, the government also provided temporary assistance to the scheme (See Box 6.04 for further details).

6.30 Retail depositors are insured up to £85,000. The scheme covers banks which are authorised to take deposits by the FSA, which includes banks incorporated in the UK (a UK bank or subsidiary of an EEA bank), and the subsidiaries of foreign banks from out with the EEA that are authorised by the UK regulator. A number of banks have complex business structures across the UK, in some cases these are groups with a number of authorised subsidiary banks and other financial companies and brands. Deposit protection is also

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75 Compensation limits for customers with deposits spread throughout several different banks would depend on the legal structure of the banks concerned and whether they were separately authorised by the FSA

http://www.fsa.gov.uk/consumerinformation/compensation/brands/banking
offered through the relevant European Economic Area (EEA) home state deposit guarantee scheme if the deposit is held in the UK by a branch of an EEA deposit taker.  

Box 6.04: Interventions to Maintain Financial Stability – Recent Financial Crisis

The responses by national authorities to the financial crisis included a package of measures. Central banks and national governments did not restrict their support to domestic institutions, and in some cases, cross-border support was provided on a joint basis.

This box summarises some of the key interventions both in the UK and overseas to support the financial system.

There were effectively three different types of intervention.

- General increase in liquidity and monetary stimulus;
- Liquidity support to individual firms; and,
- Measures to support financial institutions and maintain confidence in the financial system (through using the public sector balance sheet)

**Liquidity Support**

Perhaps the most significant source of support during the financial crisis was a substantial increase in liquidity. This was provided not just by the Bank of England but by central banks across the world, often in a coordinated manner.

At the same time, liquidity was provided to specific institutions requiring additional liquidity over and above this.

For example,

- The Bank of England provided Emergency Liquidity Assistance (ELA) in 2008 to RBS and HBOS. The ELA was provided outside the Bank’s published framework and was partially indemnified by HM Treasury.

- Central banks and national governments did not restrict their support to domestic

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institutions. As an illustration of this, estimates from Bloomberg\textsuperscript{78} suggest that banks headquartered in the UK received significant liquidity support from the US Federal Reserve. RBS received a peak level of support of $85.4bn, while Barclays received $64.9bn.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Peak Liquidity Support ($bn)</th>
<th>Date of Peak</th>
<th>Rank (based on peak assistance received)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morgan Stanley</td>
<td>107</td>
<td>9/29/2008</td>
<td>1</td>
</tr>
<tr>
<td>Citigroup</td>
<td>99.5</td>
<td>1/20/2009</td>
<td>2</td>
</tr>
<tr>
<td>Bank of America</td>
<td>91.4</td>
<td>2/26/2009</td>
<td>3</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>84.5</td>
<td>10/10/2008</td>
<td>4</td>
</tr>
<tr>
<td>State Street</td>
<td>77.8</td>
<td>10/1/2008</td>
<td>5</td>
</tr>
<tr>
<td>Barclays</td>
<td>64.9</td>
<td>21/4/2008</td>
<td>10</td>
</tr>
<tr>
<td>HBOS</td>
<td>18</td>
<td>11/20/2008</td>
<td>24</td>
</tr>
</tbody>
</table>

Source: Bloomberg

**Capital Injections and Guarantees**

Where liquidity provision was not sufficient, certain countries decided to intervene directly to support troubled institutions and provide confidence to the entire system. Some of these interventions were also coordinated across countries.

For example, in the UK:

- The resolution framework introduced in the Banking Act 2009 was not in place, and during the financial crisis the UK Government intervened directly to support a number of institutions with capital. Net cash outlays totalled £119bn including, £66bn to RBS and Lloyds Banking Group and £20bn of loans and capital to Northern Rock.
- Alongside this, financial guarantees stood at £1,029bn at the height of the crisis. This figure represented the worst possible scenario (i.e. if all assets had defaulted). The guarantees have since been wound down. For example, the Asset Protection Scheme, which contributed significantly to the total, has since been closed. The total value of guarantees is now significantly smaller.\textsuperscript{79}


<table>
<thead>
<tr>
<th>Total Cost of Financial Sector Interventions by the UK government</th>
<th>Guarantee commitments (£bn)</th>
<th>Cash outlay (£bn)</th>
<th>Total support (£bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total support – Peak</td>
<td>1,029.30</td>
<td>132.89</td>
<td>1,162.19</td>
</tr>
<tr>
<td>Outstanding – 31 March 2011</td>
<td>332.40</td>
<td>123.93</td>
<td>456.33</td>
</tr>
<tr>
<td>Outstanding – 31 March 2012</td>
<td>109.17</td>
<td>118.86</td>
<td>228.03</td>
</tr>
</tbody>
</table>

Source: National Audit Office

- There are examples of international co-operation of banks with cross border significance.
- For example, Dexia – a bank headquartered in Belgium – received assistance on three occasions. This was provided by France, Belgium and Luxembourg. During the most recent intervention, in November 2012, France and Belgium agreed to inject €4.4 billion to recapitalise the bank. Up to 53% will be provided by Belgium with the balance supplied by France.

Deposit Protection

As highlighted above, the UK Financial Services Compensation Scheme provides final protection for a number of financial products.

- During the financial crisis, HM Treasury provided loans to the FSCS totalling £20bn to provide funds for UK depositors exposed to the collapse of Icelandic Banks (Glitnir, Landsbanki and Kaupthing) in October 2008 and temporary funding to allow Abbey National (the UK arm of Santander) to continue to provide services to depositors of Bradford & Bingley.

Fiscal Policy

6.31 Under the current macroeconomic arrangements, the overall framework for fiscal policy is determined by the UK Government.

6.32 As outlined in Chart 6.01, the Scottish Government is currently responsible for approximately 60% of Scottish public spending, but (post-Scotland Act) 16% of the tax revenue raised in Scotland.

80 http://www.hm-treasury.gov.uk/fin_stability_fscs.htm
The majority of Scottish Government spending is instead financed by the Scottish Block Grant. This is currently determined in the main by the operation of the Barnett Formula.

Chart 6.01: Expenditure and Taxation Devolved to Scotland (including Scotland Act 2012)

<table>
<thead>
<tr>
<th>Scottish Tax Revenue</th>
<th>Public Expenditure for Scotland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Devolved</td>
<td>Reserved</td>
</tr>
<tr>
<td>Reserved</td>
<td>Devolved</td>
</tr>
</tbody>
</table>

Source: Government Expenditure and Revenue Scotland 2010/11

Under Barnett, changes to the Scottish Government’s budget are determined by UK Government decisions on the amount of money allocated to comparable Whitehall departments.

If the UK Government increases funding, the Scottish Government receives a comparable (per capita) share of the additional resources, and if funding decreases, the Scottish Government receives a comparable cut. This means that the level of public spending in Scotland is largely unrelated to the tax revenue raised in the country, the strength of Scotland's public finances, needs or preferences.

Further information on the Barnett Formula is provided in Box 6.05.

In addition to providing limited tax powers, the current economic framework provides little meaningful borrowing autonomy. Borrowing is only permitted to cover "a temporary excess of sums paid out of the Scottish Consolidated Fund over sums paid into the Fund" or for "providing a working balance in the Fund". Any such borrowings may only be from HM Treasury.
6.38 The Scotland Act 2012 will allow the Scottish Government to borrow for capital and current expenditure from 2015/16. Such borrowing will be tightly controlled by HM Treasury. Annual capital borrowing will be capped at 10% of the Scottish Capital DEL budget (approximately £230 million a year), will not be able to be re-profiled between years in response to economic priorities, and there will be a limit on total outstanding borrowing of £2.2 billion.

6.39 Revenue borrowing can only be used for tax forecast errors and will be limited to £200 million per annum, which will need to be repaid within four years, and there will be a cumulative revenue borrowing limit of £500 million. Borrowing to support a stimulus during a downturn will effectively be largely prohibited.

Box 6.05: The Barnett Formula

The Barnett Formula was introduced in the 1970s as a method to determine changes in funding to Scotland, Wales and Northern Ireland.

The formula applies to Scottish Departmental Expenditure Limit (DEL) funding which accounted for over 83% of Scottish Government spending in 2012-13\(^8\). It determines changes to the budget rather than the level.

A number of factors determine the calculations made for each departmental programme which collectively underpin the overall change in the Scottish Government’s Budget:

- The value of the change in planned spending by UK Government Departments;
- The extent to which the relevant UK Government departmental programme is comparable with the services carried out in Scotland; and
- Scotland’s population as a proportion of England, England and Wales or Great Britain as appropriate.

The details of how Barnett Formula operates are reviewed at each UK Spending Review and any changes are incorporated in the Statement of Funding Policy. HM Treasury consults on a draft of changes to the Statement of Funding Policy but is not obliged to make changes proposed by the devolved Governments. There are arrangements for considering and seeking to resolve disputes between the Governments.

6 The Current Framework

Once the amount allocated to the Scottish Government is calculated, it is then for the Scottish Government and Scottish Parliament to allocate spending within that budget according to its own priorities.

Scotland must also conform to any procedures and practices put forward by HM Treasury. This can have important practical implications such as access to funds held by HM Treasury on Scotland’s behalf such as recent experiences over the Fossil Fuel Levy and annual under-sPENDs demonstrate.

Public Spending

6.40 Under the current devolution settlement, the Scottish Parliament and Scottish Government have a significant degree of autonomy over the allocation of public sector expenditure in Scotland.

6.41 In 2010/11, the Scottish Government and Scottish Local Authorities accounted for approximately 60% of total public sector expenditure for Scotland across a range of spending areas as detailed in chart 6.02.

Chart 6.02: Total Public Spending For Scotland (2010/11)

Source: Government Expenditure and Revenue Scotland 2010/11
6.42 The current arrangements grant the Scottish Government responsibility for a number of policy areas that affect Scotland's long-term economic performance, such as education, transport, planning and local economic development.

6.43 Within its expenditure remit, the Scottish Government is able to determine both the policy mix and specific policy initiatives giving a degree of real autonomy over devolved policies. However, responsibility for several key areas of economic policy and government expenditure remain largely reserved to the UK.

6.44 These include economic regulation, social security, child support and pensions, foreign affairs, defence and many employment policies (See Box 6.06 for a summary list of reserved and devolved powers).

6.45 It has been argued that the split between devolved and reserved public spending and taxation and regulation can act to limit the overall effective design of government policy.

6.46 For example, the Scottish Government is responsible for spending programmes related to environmental objectives, skills development and labour market participation. However, it is not responsible for inter-related aspects of the tax, welfare or benefits systems (see Box 6.06), all of which are currently reserved and can have a significant impact upon the performance of the Scottish economy.
Box 6.06: Devolved and reserved powers

<table>
<thead>
<tr>
<th>Reserved</th>
<th>Devolved</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Constitutional matters</td>
<td>• Health</td>
</tr>
<tr>
<td>• Foreign policy and defence</td>
<td>• Education and training</td>
</tr>
<tr>
<td>• Fiscal, economic and monetary system</td>
<td>• Local government</td>
</tr>
<tr>
<td>• Welfare (unemployment, disability sickness and age-related benefits)</td>
<td>• Social work</td>
</tr>
<tr>
<td>• Tax credits &amp; child benefit</td>
<td>• Housing</td>
</tr>
<tr>
<td>• Minimum wage</td>
<td>• Planning</td>
</tr>
<tr>
<td>• EU representation</td>
<td>• Tourism &amp; local economic development</td>
</tr>
<tr>
<td>• Taxation (National Insurance, income tax, capital gains tax etc)</td>
<td>• Aspects of transport, including the road network, bus and port/harbour policy</td>
</tr>
<tr>
<td>• North Sea revenues</td>
<td>• Law and home affairs, including most aspects of criminal and civil law</td>
</tr>
<tr>
<td>• Key aspects of environmental policy (including regulation and green taxes)</td>
<td>• Police and fire services</td>
</tr>
<tr>
<td>• Financial regulation</td>
<td>• Local environment</td>
</tr>
<tr>
<td>• Economic regulation</td>
<td>• Natural and built heritage</td>
</tr>
<tr>
<td>• Immigration</td>
<td>• Aspects of agriculture, forestry and fishing</td>
</tr>
<tr>
<td>• Key aspects of energy markets</td>
<td>• Sport and the arts</td>
</tr>
<tr>
<td>• Trade and industry, including competition and consumer protection</td>
<td>• Some statistics, public registers and records</td>
</tr>
<tr>
<td>• Some aspects of transport, including international air connectivity</td>
<td></td>
</tr>
<tr>
<td>• Employment legislation</td>
<td></td>
</tr>
<tr>
<td>• Broadcasting and media</td>
<td></td>
</tr>
</tbody>
</table>

6.47 Overall, the Scottish Government is more limited in its ability to exploit potential synergies between different policy levers (including spending programmes and taxation) in the same way as other more autonomous governments can.

6.48 It has also been argued that this limits the transparency and accountability of public spending in Scotland (as well as the accountability of Scottish public spending). This is particularly important in areas such as Welfare Reform where there are potentially greater divergences between Scottish and UK Government priorities (see Box 6.07).
Box 6.07: Welfare Reform Agenda

Changes to the benefit system were announced by the UK Government in the June 2010 Budget, 2010 Spending Review and in the Welfare Reform Act 2012.

The changes include the introduction of a Universal Credit to replace existing in-work and out-of-work benefits, the freezing of Child Benefit for three years, reform of Housing Benefit and Disability Living Allowance and the limiting of up-rating benefits to 1% for two years. The changes primarily involve either restrictions on the eligibility criteria or reductions to the real terms value of benefits.

In addition to the changes outlined, other measures due to be introduced over the next few years include changes to pensions and retirement age.

What this means for people in Scotland

It is estimated that in 2012/13 £18.6 billion will be spent on benefits in Scotland. Forecast benefit expenditure in Scotland is expected to account for 8.7% of Great Britain’s expenditure (£213.1 billion), slightly higher than its population share.

In evidence to the Health and Sport Committee of the Scottish Parliament, the Department of Work and Pensions indicated that they estimate in total, welfare benefit receipts in Scotland would be reduced by ‘about £2.5 billion’ by 2015.

In addition to this, the uprating of benefits by 1% announced in the Autumn Statement in 2012 is estimated to reduce benefit expenditure in Scotland by around £210 million by 2014-15 than would otherwise have been the case.

Policy debate

There has been much discussion about the strengths and weaknesses of the UK Government’s welfare reform agenda and, in particular the potential impact on Scottish households and families. Irrespective of the merits or de-merits of these various arguments, under the current framework there are however, limited opportunities to take a different approach in Scotland from the rest of the UK. Greater autonomy would provide an opportunity to implement a different agenda but this would have to be affordable with key priorities and financial choices identified.

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82 http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?i=6766
In contrast to the degree of spending autonomy, the Scottish Parliament has limited revenue raising capacity through taxation.

At present, the Scottish Government raises 7% of all taxes collected in Scotland – see Chart 6.03.

The Scottish Government is currently responsible for local taxation, including the council tax and business rates.

The Scotland Act 2012 will provide a limited increase in these tax powers – see Chart 6.03.

Firstly, from April 2015, the Scottish Government will be responsible for a Land and Buildings Transaction Tax and a Scottish Landfill Tax.

Secondly, a Scottish Rate of Income Tax (SRIT) will be introduced in April 2016. From this date the basic, higher and top rates of income tax levied by the UK Government in Scotland will be reduced by 10 pence, with a corresponding reduction in the block grant. The Scottish Government will then effectively have the opportunity to vary the basic, higher
and top rates of income tax on earned income equally by up to 10 pence (downwards) and by an unconstrained amount upwards, and retain this revenue.

6.55 Key elements of the income tax system, such as the setting of personal allowances, and the opportunity to vary tax rates for particular groups, such as pensioners, will remain reserved\(^3\). In reality the new income tax powers provided under the Scotland Act will only permit the Scottish Government to apply limited changes.

6.56 Despite the additional tax powers that the Scotland Act 2012 will devolve, the UK Government will still be responsible for approximately 84% of Scottish tax revenues.

6.57 Responsibility for key tax levers which can have a significant impact on Scotland’s long term economic performance such as corporation tax, national insurance contributions and capital gains tax will remain reserved.

**Other Economic Policy Levers**

6.58 In addition to fiscal and monetary policies, other important economic policy levers are also reserved to the UK Government. Key reserved functions include:

- energy policy, including the oil and gas sector;
- competition policy;
- company law;
- economic regulation of utilities (e.g. telecommunications, broadcasting and energy);
- consumer protection and product and trading standards; and
- policies affecting the labour market - including employers’ social (National insurance) contributions, employment law and migration.

6.59 These are significant responsibilities which have a bearing on performance, competitiveness and hence the growth potential of the Scottish economy.

\(^3\) The Calman Commission on Scottish Devolution also recommended the devolution of Air Passenger Duty and Aggregates Levy: [http://www.commissiononscottishdevolution.org.uk/](http://www.commissiononscottishdevolution.org.uk/)
6 The Current Framework

6.60 Decisions in these areas by the UK Government can also have important consequences for the Scottish Government. For example, decisions made by UK Ministers on labour market policy, and particularly on migration, can have an important influence on demand for public services and the size of the tax base in Scotland. The reservation of these powers therefore means that the UK remains largely responsible for the framework for economic regulation in Scotland. The Scottish Government has no direct representation at the EU level.

Benefits and Limitations of the Current Framework

6.61 As outlined in this chapter, under the current framework, responsibility for macroeconomic stability rests almost entirely with the UK Government. An assessment of this position can be undertaken by looking at how the current framework can contribute to the delivery of the Scottish Government’s two overarching objectives for a macroeconomic framework of long-term competitiveness and short-run responsiveness.

Long-term competitiveness

6.62 The Scottish Government has significant levers to shape spending programmes, for example, on education and skills. It does however lack the ability to shape the regulatory and tax environment, levers that are vital to boosting Scotland’s long-term competitiveness. As highlighted above, the Scottish Government currently has responsibility for 7% of tax revenues raised in Scotland.

6.63 It can be argued that a unified or centralised approach may provide benefits in terms of economies of scale. It can also, in theory, help promote the effective operation of a single market and thereby boost competitiveness. This is mitigated somewhat by international trends toward free-trade.

6.64 On the other hand, it can also be argued that this constrains the opportunities to promote long-term competitiveness appropriate for the local economic area. For example, under the current arrangements, Scottish Ministers do not have the authority to put in place a more competitive business tax structure. In the context of Scotland, flexible and targeted

measures to boost overall competitiveness can be important as a counter to the natural competitive advantage of one very large economic region through internal and external economies of scale (i.e. London and the South East) and which also dominate policy making.

6.65 Similarly there are constraints, not just in boosting overall competitiveness but also, in specific areas of relative importance to Scotland where a ‘one-size-fits-all’ approach may not be optimal.

6.66 For example, the current framework means that the Scottish Parliament does not have significant responsibility for policies that have an impact on the North Sea oil and gas industry. It is estimated that approximately 80% of UK oil and gas production takes place in Scottish waters\(^85\), with Scotland’s share of offshore tax revenue higher still due to the relatively higher profitability of Scottish fields. Scotland also accounts for 85% of remaining reserves suggesting that the sector will be an important part of the Scottish economy for the foreseeable future. At the same time Aberdeen has established itself as a global energy hub with expertise and skills across the supply chain. However, the Scottish Government is unable to tailor the fiscal regime to support long term investment in this sector, or in the related engineering services.

6.67 Similarly, it can also be argued that the lack of autonomy limits the ability of the Scottish Government to respond to particular challenges that are unique to Scotland but are less important at the aggregate UK level – for example, international air connectivity.

6.68 Under the current arrangements, the UK Government can also take an asymmetric approach to the devolution of powers, for instance, reviewing if they should transfer Air Passenger Duty and Corporation Tax powers to Northern Ireland but not to Scotland.

6.69 It is not just in economic policy where there are constraints. For example, many of the key levers to tackle environmental issues are reserved, including support for innovation in areas such as carbon capture and storage, environmental regulation and global environmental agreements.

6.70 Not only does this limit the economic levers available to the Scottish Government, it also limits the effectiveness of existing levers. As outlined above, public spending measures are most effective when accompanied by complementary reforms to the tax and regulatory system. Under the current framework the Scottish Government is unable to fully exploit these synergies.

6.71 In relation to monetary policy and financial stability the Scottish Government has no influence to shape policy or to provide oversight.

Short-run responsiveness

6.72 The current funding mechanism provides a degree of funding certainty and stability over a spending review period (typically a 3 year period). This allows the Scottish Government to prioritise and allocate these funds across key devolved areas (housing, transport, health and education) with a degree of certainty.

6.73 However, this funding is largely determined by changes in spending on equivalent programmes in England and is not directly linked to the preferences of Scottish households or businesses, or their willingness to pay for the provision of services.

6.74 Being part of a larger economic and fiscal union can offer a degree of macroeconomic security. In theory, one region or country can be supported by transfers from other areas in times of economic downturn. An element of this pooling of risk is provided automatically in the current UK framework through the operation of a unified social security system. However, such benefits may be balanced by the fact that a consolidated response to an economic shock may not reflect the specific needs of a local economy. It should also be noted that, as highlighted in Chapter 4, many countries of comparable size to Scotland perform well on key economic indicators (see for example Table 4.04) under a range of macroeconomic frameworks.

6.75 Finally, it can be argued that the current framework limits accountability and transparency by failing to provide a visible link between Scottish public expenditure and tax choices. In 2010/11, the Scottish Government and local authorities were responsible for £36 billion of public expenditure in Scotland but collected approximately £3.9 billion in tax revenues.
By linking expenditure with revenue (and/or borrowing), it could be argued that greater autonomy encourages more rigour in the budget process through consideration of both the marginal costs and/or benefits of changes in public spending and taxation. Crucially, successful policies lead to additional resources, while unsuccessful policies lead to lower resources.

The Scotland Act 2012 aims to help address this, but is limited in its scope.

Conclusion

The Scottish Government has significant control over the composition of public spending in Scotland but limited autonomy over raising the tax revenues to fund these expenditures. Even after the financial provisions of the Scotland Act 2012 are put in place, the Scottish Government will only be responsible for approximately 16% of tax revenues.

Some of the key policy levers which determine the long-run competitiveness of the Scottish economy, so-called micro-levers such as education and training, are already available to the Scottish Government. Unlike many other devolved governments in other countries, the Scottish Government has complete autonomy over how to use these powers. This represents a significant degree of autonomy.

In contrast, the Scottish Government has limited control over the taxation system. It also has limited authority over the overall spending envelope and key spending decisions such as welfare (see Box 6.06) and the regulatory framework.

The Scottish Government is therefore constrained in its ability to create and implement policies that will support long-term competitiveness and short-run stabilisation. This chapter has demonstrated a number of arguments that highlight where the current tax, spending and borrowing arrangements potentially inhibits the ability of the Scottish Government to deliver faster sustainable economic growth and to tackle inequalities.

Alongside this however, the Scottish economy benefits from being part of an integrated market with the rest of the UK and the EU. Evidence in favour or against economies of scale in public policy provision is unclear – though it is important to recognise that they may exist. Finally, the integrated public finance framework provides an element of risk pooling and collective action. This occurs primarily through the social security system.
6 The Current Framework

providing a ‘transfer’ mechanism if there was ever a divergence in economic performance. An alternative approach to relying upon transfers would be to provide policy levers to tackle these challenges directly.

6.83 In addition, there is currently no meaningful link between Scotland’s economic performance and the size of the Scottish Government’s budget. This means there is very little to link the success, or otherwise, of Scottish Government policies and the future resources available to it. Under the current framework, if the Scottish Government introduced a policy which improves Scotland’s economic performance, for example by increasing labour market participation, it will retain just a fraction of any of the additional tax revenue generated as a result.

6.84 Finally, there is no oversight or accountability of key macroeconomic institutions – such as in financial regulation or the Bank of England – to the Scottish Parliament or Scottish Government.

6.85 The next chapter considers the design options for an independent Scotland for monetary and financial stability. Chapter 8 will then go on to discuss design options for the fiscal framework.
7: Monetary and Financial Stability – Design Options

Chapter Summary

- Chapter 7 provides a summary of the design options available to an independent Scotland for a framework to deliver monetary and financial stability.

- With independence, the Scottish Parliament would be fully responsible for the design of policies to deliver monetary and financial stability in Scotland.

- It could seek to implement its own policy and/or look to work with key partners to deliver shared objectives.

- Central to the operation of monetary policy would be the choice over which currency to adopt, either establishing a separate Scottish currency or seeking to be part of a monetary union.

- Overall, the choice of currency will have a significant impact on the future performance of the Scottish economy, influencing trade flows and investment.

- There are on-going moves at the EU level and internationally which provide important context for the design of a framework for financial regulation and tools to ensure financial stability in an independent Scotland.

- Given the close linkages between these two pillars of the macroeconomic framework – for example, the importance of the commercial banking sector in transmitting monetary policy to the real economy – they are discussed jointly in this chapter.

- The design options for a fiscal framework are considered in Chapter 8.

Introduction

7.1 As highlighted in Chapter 5, central to any macroeconomic framework is a stable and credible framework for monetary and financial stability.
7 Monetary and Financial Stability – Design Options

7.2 At the time of independence, the Scottish Government would be required to identify a new monetary framework for Scotland. This could involve seeking to continue to use the existing framework through a negotiated settlement with the rest of the UK, or establishing a distinct approach in Scotland. Timing is important, and there may be opportunities to establish temporary or transitional arrangements.

7.3 Central to this is the choice of currency. It is this decision, above all others, that has the greatest implications for the overall structure of the framework. It also has implications for the type of institutions to be established.

7.4 This chapter sets out the currency options that would be available for Scotland post-independence and identifies a number of key issues with regard to the choice of monetary and financial stability arrangements. The chapter then sets out three key foundations of financial stability (supervision, resolution and deposit protection) and the arrangements that could be established to support this.

7.5 Monetary and financial stability are discussed together in this chapter. This reflects the substantial overlap between these two policy areas and the important role of the central bank in both elements of the macroeconomic framework.

Currency Options

7.6 There are a variety of economic factors which are worthy of consideration when assessing the merits of currency options open to an independent Scotland.

7.7 The choice of currency, by dictating both the fundamental structure of the monetary framework and the relationship with other countries, will also have implications for decisions over the overall shape of the public finances and financial stability.

7.8 For example, if Scotland sought to join a monetary union then it would be likely to commit, not just to the operation of monetary policy of that currency area, but also a range of conditions that may be associated with that membership.

7.9 The principal currency options open to an independent Scotland are highlighted in the diagram below.
New Scottish Currency

7.10 The creation of a new currency would give policy makers in Scotland maximum policy flexibility, subject to any practical constraints associated with establishing and operating a credible and sustainable currency.

7.11 The economic area of Scotland is sufficiently large to support its own currency.

7.12 In the long run, the creation of a new Scottish currency would represent a significant increase in economic sovereignty, with interest rate and exchange rate policy being two new policy tools and adjustment mechanisms to support the Scottish economy.

7.13 In the short-run there would however, be a number of practical challenges associated with moving to a new currency, including the not insignificant steps required to re-denominate contracts and maintain intra-UK supply chains.

7.14 Ultimately the value of a Scottish currency would depend upon Scotland’s balance of payments position. The handling of currency receipts from the North Sea – including the extent to which such transactions were denominated in Scottish currency – would be important both for managing the balance of payments and exchange rate movements.
7 Monetary and Financial Stability – Design Options

the short-run, the credibility of any new currency as a medium of exchange would be a key determinant of its value.

7.15 There would be a choice regarding whether to adopt a fixed or flexible exchange rate.

7.16 The currency could ‘float’, adjusting automatically in value in response to changes in the demand and supply for the Scottish currency.

7.17 Alternatively it could be pegged to another currency or a basket of currencies. This is the case for a number of countries which have their own currency. An obvious option would be to aim to peg 1:1 with Sterling.

7.18 Within this, one possibility is establishing a currency board. This is the strictest form of currency peg and aims to maintain a permanently fixed rate of exchange between one currency and a “reserve currency” supported by full convertibility. It requires sufficiently large reserves of the pegged currency (e.g. Sterling) at the legally enforceable rate.86

7.19 Under each of these scenarios, new institutions would need to be developed - the principal one being a Scottish Central Bank. It would be responsible for delivering monetary policy (either to target inflation or to peg the value of the currency), providing liquidity to the financial sector and ensuring the credibility of the currency as a medium of exchange.

Monetary Union

7.20 An alternative to establishing a new currency would be to enter into a formal monetary union.87

7.21 Joining a formal monetary union would be subject to agreement and cooperation from partners within the union. In a monetary union, monetary policy is set for the entire currency zone.

86 Hong Kong has successfully operated such a system for many years with a strict peg to the US dollar

87 For further discussion on the currency choices available to Scotland see: Scotland’s Currency and Fiscal Choices, National Institute Economic Review, Armstrong, A, January 2012
7.22 Joining, or remaining part of, a monetary union could have the benefit of adopting a system which is well established and has credibility in international financial markets.

7.23 The key benefit of a monetary union is the positive effect on trade. By adopting the same currency, a monetary union eliminates transactions costs and exchange rate risk. In addition, a single currency can facilitate price comparisons and encourage competition.

7.24 The other key benefit is a stability and uniformity in financial conditions across the currency zone. This can help to create a single investment area boosting liquidity and capital deepening. This should enhance the efficiency and volume of investment; indeed this appears to have been one of the main achievements of the Euro Area’s single market.

7.25 Against this, a monetary union means that there will be one interest rate and exchange rate for the entire economic union. This requires broad alignment of business cycles (close enough to enable fiscal policy to smooth any divergences) and similar economic structures so that changes to the common monetary policy have similar effects across the monetary union.

7.26 As an aside, there is the option for Scotland to adopt Sterling through an informal process of ‘sterlingisation’. While this option would retain some of the benefits of a formal monetary union there would also be some additional drawbacks. In this instance, the Scottish Government would have no input into governance of the monetary framework and only limited ability to provide liquidity to the financial sector - this would depend on the resources and reserves of the country. The amount of currency available would depend almost entirely on the strength of the Scottish Balance of Payments position.

7.27 The two clear options for Scotland are therefore to seek to join a formal monetary union with Sterling or the Euro.

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88 Hedging costs are likely to be proportionally more expensive for small and medium sized companies who are unable to take advantage of the most competitive rates on offer to multinationals.
Monetary Union Options for Scotland

Sterling

7.28 Entering a monetary union with sterling would largely be a continuation of the current monetary framework. The Bank of England could operate day-to-day monetary policy independently from both the Scottish and UK Governments.

7.29 There are a number of ways that this could be achieved.

7.30 Two key issues relate to i) governance and ii) whether or not separate central banks are created in each jurisdiction. Both would be subject to negotiation and agreement with the UK Government. Discussions on such arrangements would focus on the objective of financial and economic stability.

7.31 In respect of governance, it is important to note that negotiations would begin from a position where the Bank of England is currently the central bank for both countries.

7.32 Going forward, one option would be to create a formal monetary union with two equal partners each having the same degree of oversight and input into the governance of the ‘shared’ central bank. An alternative model would be to establish governance on a ‘shareholder’ basis, according to the relative economic (or population) size of the partners.

7.33 In terms of the creation of a new institutional and governance structure, two options are possible. The first option would be for a supranational central bank to be established for the Sterling Zone (similar to the ECB) with two satellite central banks (Central Bank of UK and Central Bank of Scotland) tasked with carrying out day-to-day monetary and liquidity operations and implementing the decisions of the ‘Sterling Zone Bank’. A second option, and the most straightforward option at the outset, would be to retain one independent central bank (i.e. the Bank of England) across both countries but subject to accountability, oversight and indemnification from two separate fiscal authorities on an agreed basis.
The Euro

7.34 In principle, an independent Scotland could apply to join the European Monetary Union, adopting the Euro as the currency.

7.35 Within the Euro Area, monetary policy, including control of both the interest and exchange rate, would be the responsibility of the ECB and set for the entire Euro Area.

7.36 Determining eligibility to join the Euro would not be straightforward for a newly independent Scotland as a number of conditions have to be satisfied before this can be achieved (See Box 7.01). Establishing whether Scotland meets those criteria is not immediately possible since the nature of the current devolved settlement means that measurement of these economic criteria does not yet exist.

7.37 It is also not the case that a newly independent Scotland could be obliged to join the Euro. As highlighted in Box 7.01 for example, a requirement to join the Euro is to be a member of the Exchange Rate Mechanism II for at least two years. The decision to join the ERM II is voluntary.

Box 7.01: Steps Required to Joining Eurozone

There are a number of criteria required to be satisfied by countries before joining the Euro Area. These criteria are set out in Article 140 of the Treaty of the Functioning of the European Union.

In particular, there are four main convergence criteria:

- **Inflation rate:** No more than 1.5 percentage points higher than the three lowest inflation member states of the EU;
- **Government finance:** Ratio of annual deficit to GDP less than 3% and ratio of gross debt to GDP less than 60%;
- **Exchange rate:** Applicant countries must have been a member of the Exchange Rate Mechanism II for 2 consecutive years and should not have devalued its currency during that period; and
- **Long-term interest rates:** The nominal long-term interest rate must not be more than two percentage points higher than in the three lowest inflation member states.
7 Monetary and Financial Stability – Design Options

From the perspective of an independent Scotland, all four criteria would be difficult to meet immediately – not from the perspective of the relative strength of the Scottish economy but simply due to current system creating an inability to demonstrate a track-record of having met the criteria.

Assessing the options

7.38 There are a number of important issues to consider when choosing the optimal currency arrangement for Scotland post-independence.

7.39 The most straightforward way to assess the options is to compare the benefits of monetary policy targeted to developments in the national economy (and in particular the opportunity to devalue/depreciate the currency) against the benefits of membership of a common currency area which include lower transaction costs, price transparency, a single investment area and reduced exchange rate risk.

7.40 The criteria typically used to make such an assessment includes a range of considerations such as –

- trade (both intermediate and final goods & services) between members of a proposed currency area compared to trade with countries outside the proposed currency area;
- capital and labour mobility;
- wage and price flexibility;
- productivity; and,
- alignment of economic cycles.

7.41 Alongside this report, the Working Group has published a summary of the strengths and weaknesses of the major currency choices for Scotland, across five broad areas of assessment –

- Are the fundamental structures of the Scottish economy currently suited to such an arrangement?
- Are there any benefits/implications for short-term macroeconomic stabilisation?
• What are the potential implications for trade and investment?
• How straightforward would the transition arrangements be; and,
• What policy levers would be open to a future Scottish Governments to address the key challenges and take advantage of new opportunities in the Scottish economy?

7.42 In practice, any assessment of the optimal monetary framework is open to interpretation.

7.43 Moreover, the best structure may vary over time depending upon developments in both the Scottish economy and possible partner economies within a currency union. All things considered, the current evidence points in favour of retaining Sterling as part of a formal monetary union.

7.44 This would also be in the benefit of the UK, given the trade links with Scotland, and the nature of integrated markets, such as in financial services.

7.45 Box 7.02 provides a summary of the suitability of retaining Sterling.

**Box 7.02: Summary of arguments in favour of retaining Sterling**

An independent Scotland would have a range of positive choices with regard to its macroeconomic framework.

On Day one of independence, the Members of the Working Group agree that retaining Sterling would be a sensible currency choice that would be attractive both to Scotland and the UK.

There are a number of reasons for this.

Firstly, Scotland is an open economy with the UK as its principal trading partner, accounting for two thirds of onshore Scottish exports. Export sales to the UK are equivalent to around 17% of total turnover in the Scottish economy. While robust figures on imports are not yet available, it is clear from the modelled data that does exist – both from Scottish Input-Output tables and new SNAP experimental data – that imports from the Rest of the UK are likely to be at least as large as the figures for Scottish exports.
Secondly, while less than 2% of registered enterprises operating in Scotland are ultimately owned by enterprises from the UK, they account for approximately 20% of employment and turnover\(^89\). There is also clear evidence of the existence of a number of significant pan-UK companies operating in Scotland (and vice versa) with complex cross-border supply chains.

Thirdly, there is also labour mobility between Scotland and the UK – helped by strong transport links, culture, recognised education qualifications and a common language. Historically, the vast majority of inward migration into Scotland has been from the UK. This has changed somewhat in recent years following the accession of new Member States to the EU. In 2010-11 however, over 50% of migration flows into and out of Scotland was still from the UK\(^90\).

Fourthly, as highlighted in Chapter 4 on long-term measurements of economic performance, the Scottish and the UK economies are broadly aligned. For example, the latest data for 2011 has Scottish productivity at either 97% or 99% of the UK average depending upon the measure used, while GVA per head in Scotland (even excluding the contribution of the North Sea) during 2011 was 99% of the UK average – 3\(^{rd}\) behind London and the South East.

Fifthly, past evidence of business cycles shows that while there have been periods of temporary divergence, overall there is a relatively high degree of synchronicity compared to other closely related economies. Analysis has shown that Scotland and the UK have closer economic cycles than most other European economies (see accompanying paper on the Fiscal Commission Working Group web page). The chart below shows that on only two occasions have the business cycles of the UK and Scotland diverged by more than 2 percentage points, and this was only a temporary divergence. The scale, length and frequency of asymmetric shocks is also limited, based upon historical evidence.

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\(^89\) Scottish Corporate Statistics 2012

Employment levels are also broadly similar between Scotland and the UK.

Historically, there have been different patterns in house price levels and movements in Scotland compared to the UK. House prices in Scotland were broadly flat in real terms from the early 1970’s until the late 1990’s, whilst in comparison there were greater fluctuations in the UK over this time period. Since then, price movements across the UK (excluding Northern Ireland and to a lesser extent London and the South East) have tended to be more aligned. The most recent data shows that house prices in Scotland tend to be lower than the UK average but similar to most areas outside London and the South East.

Due to links between the short-term interest rate and consumer spending, variations between housing market structures can influence the way in which monetary policy, through the interest rate transmission mechanism, has an impact on different parts of a single currency area. Over the last two decades, home ownership in Scotland has significantly increased to broadly converge with the UK.

In summary, this assessment suggests that monetary policy set to promote price and financial stability across a Sterling Zone would, as an initial assessment, appear to be consistent with the objectives of delivering a stable macroeconomic system for Scotland.

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91 In 2011, 63.9% of all dwellings in Scotland were owner occupied, compared to 64.7% in the UK
Finally, retaining Sterling would be a useful mechanism to help assist with the transition to independence. Adopting Sterling would give any new governance institutions time to establish credibility, and the new economic institutions (a Scottish Treasury, tax collection, fiscal monitoring/oversight agencies) time to develop effective institutional capacity.

It would also provide a stable environment to resolve negotiations on the division of public sector debt and assets. It would also give lenders certainty over the future value of debt repayments and would provide stable conditions for investment in the Scottish economy.

Frameworks of successful Monetary Unions

7.46 As highlighted above, the choice of currency has implications not just for monetary policy, but also other aspects of the macroeconomic framework including financial stability and fiscal policy (and vice versa).

7.47 There are a number of existing institutional structures and mechanisms in place for the Euro Area which continue to be developed. Given recent lessons from the Euro Area, a more carefully engineered framework would be beneficial for a Sterling Zone. These could be devised to build upon recent experiences in Europe.

7.48 Key institutional requirements for a robust monetary union are:

- Commitment to common goals on financial stability and fiscal sustainability - with national institutions that share these goals;
- Clear democratic accountability of supranational authorities;
- The ability to manage systemic risk across the monetary union – requiring an integrated financial system, with elements of a ‘banking union’ that includes aligned prudential supervision and clear procedures for crisis management;
- A clear framework to ensure fiscal discipline and credible commitments to adhere to fiscal sustainability, whilst providing national discretion to target instruments of fiscal policy to address key local challenges and to take advantage of new opportunities; and,
- A commitment to promote cross-border competition and flow of factors of production (i.e. eliminate barriers to trade and factor movements) to not only drive innovation and improve competition but also facilitate the macroeconomic adjustment process. Wage and price flexibility can help facilitate changes in relative production costs and competitiveness.

7.49 Recent events in the Euro Area show that the initial framework for that monetary union was under-designed. The countries were not convergent in terms of economic criteria and as a result the framework was not sufficiently robust to mitigate or respond to significant economic or financial shocks.

7.50 This posed challenges for both financial stability and fiscal policy.

7.51 For example, the creation of the Euro led to moves towards closer financial market integration without there being a common approach to financial stability, supervision and crisis management. During the recent financial crisis, some of the instabilities that developed within the Euro Area were partly as a result of poor oversight of banks with significant cross border operations. A system in which responsibility for oversight of multinational financial institutions lie primarily with national governments is insufficient to safeguard financial stability. The emerging proposals on Banking Union aim to address these shortcomings – see Box 7.04.

7.52 In response to fiscal imbalances in the Euro Area, the European Fiscal Compact has also been developed as part of the larger Treaty on Stability, Coordination and Governance. This is an intergovernmental agreement to abide by a set of pre-determined fiscal rules. Euro Area members must (and non-Euro Area states can choose to) introduce a legally binding correction mechanism that is automatically triggered if a Member States’ deficit exceeds pre-determined limits or fails to converge within a pre-determined time frame.

7.53 It has been suggested that a currency union between Scotland and the rest of the UK could immediately lead to a Euro-style crisis. This is a false argument. Ultimately suitability to a currency union depends upon the unique structures of the particular countries and currency union in question. It is simply not a fair or accurate comparison to contrast a

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currency union between Scotland and the UK with that of a currency union with 17 members ranging in economic performance from Germany to Greece – see the discussion in the accompanying currency paper. Currency unions between economies that broadly share the same macroeconomic characteristics and have in place effective and well-designed structures and institutional frameworks can be successful.

7.54 An example – albeit not a model directly replicable in Scotland – is the Belgium and Luxembourg currency union (see Box 7.03).

7.55 Overall, a Sterling Zone currency union would be starting off from an institutionally and structurally stronger position compared to the Euro Area.

7.56 For example, both Scotland and the UK have experienced the same structural and institutional changes over time (e.g. labour market reforms, free capital markets). This has led to integrated and flexible product markets and relatively free movement of factors of production – important in responding flexibly to Sterling Zone economic events.

7.57 In the context of designing a monetary framework, many institutions are also already established. For example, a framework for managing day-to-day monetary policy exists (the ‘Sterling Monetary Framework’); key financial infrastructure (e.g. payments and settlements system) is already established on a pan-UK basis; and financial supervision and oversight of banks and financial institutions which operate across the UK are already aligned.

7.58 As the following sections in this chapter outline, it is important to design effectively the foundations of supervision, resolution and deposit protection across a monetary union. This approach to financial stability is also an important foundation for sustainable fiscal and monetary frameworks to be successful.
The Belgium-Luxembourg Economic Union (BLEU) was established in 1922.

Luxembourg is now ranked as one of the richest countries in the world, with a nominal GDP per capita more than twice that of Belgium’s.⁹³

Reflecting the considerable disparity of size (Belgium’s population is roughly twenty times Luxembourg’s), Belgian francs under BLEU formed the largest part of the money stock, and enjoyed full status as legal tender in both countries.

The BLEU framework demonstrates therefore that relative differences in country size and economic structure do not prevent successful monetary union. It was characterised by:

- Monetary and Financial Stability.
- Successful monetary union (between one larger country and one smaller one).
- Fiscal freedoms within monetary union.
- Coordination of monetary institutions (i.e. Belgian Central Bank and Luxembourg Monetary Institute).
- Co-operation in key systemic risk areas (i.e. MoU on financial regulation).

Only Belgium had a full-scale central bank. However, this was supported by formal joint decision-making bodies.

Whilst both countries were in a monetary union, there were significant differences in the particular spending and tax policies adopted. For example, differences in the VAT rates which have persisted to the present day - standard VAT remains at 21% in Belgium and 15% in Luxembourg.

There were also significant differences in the corporation tax rates of Belgium and Luxembourg – for example, in the 1990’s the central government corporate tax rate in Belgium averaged 40% compared to an average rate of 33% in Luxembourg. In 2012 differences still remain, the combined corporate income tax rate in Belgium is 34% compared to 28.8% in Luxembourg⁹⁴.

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⁹⁴ OECD Tax Database, http://www.oecd.org/tax/taxpolicyanalysis/Table%20II.1.xls
Implementation of Monetary Policy

7.59 In addition to deciding on the appropriate currency for an independent Scotland, new monetary arrangements would follow to deliver an effective monetary policy strategy.

7.60 If Scotland were to join a monetary union, these arrangements would be harmonised to ensure a consistent delivery of monetary policy across members.

7.61 For example, there is an established framework for the delivery and implementation of monetary policy across the Euro Area. This includes guidelines on the requirements of each member country to deliver the policy and wider objectives of the monetary system of the Euro Area, which Scotland would follow if it were part of the Euro Area.

7.62 Retaining Sterling would require establishing a new framework for delivery of monetary policy across the Sterling Zone. This should be relatively straightforward and be able to take advantage of institutions already in place and which currently operate monetary policy for the whole of the UK. For instance, as part of a formal monetary union, there could be continued use of a shared central bank.

7.63 Another option, including if there was a separate Scottish currency, would be to set up a central bank in Scotland. Within an own currency model, choices would also be made on the practical operation of monetary policy, including the remit of the central bank, its goals, objectives, transparency and accountability.

7.64 Alongside ensuring the smooth operation of the monetary system, a Central Bank for Scotland with its own currency would also be the responsible for other functions, such as the management of currency reserves and foreign asset reserves.

7.65 As part of the option of setting up a new Scottish Central Bank, the central bank could be capitalised using a fair share of existing Bank of England assets.\(^5\)

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\(^5\) The Bank of England was nationalised in 1946 and would therefore by part of the assets to be negotiated
As highlighted in previous chapters, another important role for central banks, in conjunction with the relevant fiscal authority, is to act as the provider of liquidity to financial institutions operating in their jurisdiction.

Under independence, and with a separate Scottish currency, financial institutions operating in Scotland may require liquidity support and it would be the role of the relevant central bank to provide this support.

**Financial Stability**

Under independence, the Scottish Government would have the opportunity to judge the most appropriate framework for delivering financial stability for Scotland. Key decisions would be required in respect of supervision, crisis management, resolution and deposit protection.

Given the importance of financial stability to the global economy, there is important international context which needs to be considered as part of the design of a framework. For example, the UK Financial Services Authority have estimated that around 70% of their policymaking effort is driven by EU initiatives.

For an independent Scotland there would however, still be a wide range of institutional and regulatory options to be considered within these overarching parameters. Across the EU there is no single financial stability or regulatory framework model adopted by Member States. As will be set out below however, there are moves toward greater coordination and cooperation.

The emerging proposition for a macroeconomic framework, which is set out in Chapter 9, outlines a preference for financial stability to be coordinated across Scotland and the UK post-independence. However, as part of the development of this proposition full consideration has been given to the range of alternative options available.

As part of this assessment - and as discussed in the next section - it is important to recognise that a successful financial sector is of key importance to the Scottish economy.

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96 [www.fsa.gov.uk/about/what/international](http://www.fsa.gov.uk/about/what/international)
both as a direct employer and through facilitating growth in the wider economy through
the range of financial products and services it provides, including lending to businesses and
households. However, because of the public good nature of financial stability, the sector
requires effective and efficient supervision and oversight.

Scottish and UK Financial Services Sector

Scotland is home to a successful and diverse financial services industry with key
international strengths across a range of activities including banking, asset management,
pensions and insurance.

These institutions have significant presence across the UK. Their activities are therefore
vital, not just for the Scottish economy, but the UK economy as a whole.

Scotland’s share of GB financial services employment stood at 8.1% in 2011. The share of
employment varies across subsectors. For example, there is a particular concentration of
activity in the life and pensions in Scotland which accounts for 28.5% of total GB
employment in the industry. Scotland also continues to experience growth in the asset
management sector – employment in the sector increased from 13,500 in 2010 to 15,600
in 2011.

Scottish companies have a prominent role in the market for personal current accounts
(PCA’s). For example, in 2010 it was estimated that Lloyds Banking Group and RBS hold
approximately 46% of all PCA’s in the UK and around 35% of all mortgages. Key corporate
and headquarter functions of these institutions are also spread across different parts of the
UK. For example, RBS’s investment banking arm is located in the City of London.

At the same time, institutions headquartered in other parts of the UK have substantial
operations in Scotland and play an important part in the success of the Scottish economy.
For example, commercial banks such as Barclays, HSBC and Santander have substantial
operations in Scotland. New entrants to the financial services sector - such as Tesco Bank
and Virgin Money - have also established a strong presence in Edinburgh and Glasgow

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97 Business Register and Employment Survey (BRES)
98 While Lloyds registered office is in Edinburgh the majority of its corporate headquarter functions are located in London
whilst many insurance companies – such as Aviva – have major corporate operations in Scotland.

Chart 7.02: UK Market Share of Personal Current Accounts (2010)

This provides important context for the design of policy to ensure financial stability in an independent Scotland. In particular, given the nature of the existing financial sector in the UK there would be a clear shared interest for both Scotland and the UK in maintaining a stable, integrated and well-functioning financial system across both countries.

In reality a future UK Government and central bank post-independence would have a major self-interest in the adequacy of supervisory arrangements for institutions based in Scotland and operating in the UK, and vice versa.

For example, the UK Government’s support for RBS and Lloyds Banking Group in 2008 and 2009 was not, as some have suggested, a bail-out for the Scottish financial services industry. But instead it was part of a series of decisions designed to support the entire stability of the UK financial system (see Box 6.04).

Source: OFT, Review of barriers to entry, expansion and exit in retail banking, November 2010.

http://www.oft.gov.uk/shared_oft/personal-current-accounts/of1282
7 Monetary and Financial Stability – Design Options

7.81 This suggests that there are likely to be significant benefits for both Scotland and the UK from relatively close coordination of key aspects of financial stability policy post-independence. This would ensure effective oversight and guard against free-riding and burden shifting. Such cooperation is likely to be of benefit irrespective of the choice of currency or monetary system, although it is likely to be of greater importance in a monetary union.

7.82 Indeed such an approach would be consistent with the growing trend toward greater international cooperation between national authorities in the common interest of financial stability, particularly in the light of the increasingly global nature of modern financial markets and financial institutions (see Boxes 7.04 and 7.06).

Framework for Financial Stability

7.83 As highlighted in Chapter 5 and 6, certain aspects of financial regulation relate directly to macroeconomic stability. There are also other aspects of financial regulation, which include consumer protections issues. These elements will be considered further in future work by the Scottish Government. The focus of this chapter is on the main aspects which relate to macroeconomic stability.

7.84 In addition to a robust monetary framework to underpin the smooth operation of money markets and the efficient provision of liquidity, when considering the options available for financial stability this chapter focuses on the key aspects of financial stability policy:

- Supervision and Oversight
- Crisis Management, Resolution and Deposit Protection

7.85 As highlighted in Chapters 5 and 6, a number of these areas are currently under reform. For example, the UK Government is in the process of establishing a new regulatory framework while moves are afoot in Europe toward the establishment of a Banking Union (see Box 7.04).
Prior to the financial crisis, each of the 17 Euro Area Member States had their own regulatory frameworks in place. The failure of regulators to monitor risks within individual institutions, and the subsequent potential contingent liabilities of the public sector, was a key driver of the sovereign debt crisis in a number of Euro Area countries.

It also became apparent that a number of financial institutions had significant cross-border operations and so required a co-ordinated response between national governments and regulators. In the light of both experiences, there is growing recognition of the benefits of greater international supervision and burden sharing.

In response, there have been a number of reforms related to financial stability policy in Europe. The European Commission is also developing plans for a Banking Union based upon four pillars:

- **Single Rulebook** - Three European Supervisory Authorities (ESAs) have been established to create a single EU rulebook. The European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) will develop technical standards, and also issue guidance and recommendations. This includes a set of common standards for bank capital as provided by BASEL III.

- **Supervision** - In December 2012, the ECB was formally tasked with the key role in the Single Supervisory Mechanism for the largest Euro Area banks. National supervisors will undertake day-to-day operation of supervision activities for smaller institutions (subject to the authority of the ECB) but for the largest institutions authority will pass from national regulators to the ECB.

- **Deposit Guarantees** - The EU requires that Member States offer deposit insurance set at €100,000 or the local currency equivalent. In 2010, the European Commission proposed a new directive to further harmonise the EU system of deposit guarantees.

- **Resolution** - To avoid the need for future interventions that require taxpayer support, proposals for an improved framework for national resolution systems are being developed. The EU has proposed for a significant proportion of any cost to be borne by the private sector under a “bail-in” mechanism. In addition, the European Stability Mechanism (ESM) was established in September 2012 as a permanent mechanism for providing financial assistance to Member States for the purpose of re-capitalising financial institutions. Over time, the ESM may be able to provide support to Euro Area banks directly.


7 Monetary and Financial Stability – Design Options

7.86 The Working Group believe that it is essential for any proposed macroeconomic framework for Scotland to be consistent with such trends – and be sufficiently flexible – to be able to respond to emerging developments at the EU level and internationally. Indeed it is highly likely that by 2014, the landscape for financial stability – and in particular the degree of cross-border cooperation – will have changed dramatically.

Supervision and Oversight

7.87 As part of the macroeconomic framework, an independent Scotland would be required to establish a framework which ensures the effective regulation of financial institutions.

7.88 Working Group members have considered a range of options as part of the process to develop the proposed framework that is detailed in Chapter 9. In this regard, the options considered in this chapter assume that an independent Scotland remains a member of the European Union. Therefore, it is important to note that in order to meet financial supervisory and regulatory roles, EU Member States are required to designate one or more competent authorities to oversee financial regulation.

7.89 There are a number of institutional structures and arrangements that Scotland could adopt to achieve this.

7.90 Indeed, it is evident that there is no definitive or universal definition or model for financial supervision and oversight. Arrangements to maintain financial stability vary significantly, for example:

- Countries can use different institutional and technical structures such that financial services regulators can have different roles and objectives.
- There is no optimal regulatory framework, although there is consensus that a greater focus on total system risks is needed and that the bodies regulating them should be independent of government.

7.91 The exact design of the operational independence of the regulators from government is also a key factor that can vary between countries as set out in Box 7.05.
Box 7.05: Considerations for Establishing Financial Sector Regulators

Government has a role in setting and defining regulatory and supervisory goals. However, once a framework is in force, there is a general consensus that regulators should be free to determine how to achieve these goals - and should be accountable for delivering them. The IMF identify several key forms of independence:

- **Regulatory independence** - Authorities that are able to set regulations independently are more likely to be motivated to enforce them. They are also able to adapt the rules quickly and flexibly in response to changing conditions in the global marketplace.
- **Supervisory independence** - Supervisors should work closely with financial institutions, inspecting and monitoring them and also enforcing sanctions.
- **Institutional independence** - Clear rules must govern the appointment and dismissal and tenure of senior personnel. Decision making should be open and transparent.
- **Budgetary independence** - Senior personnel should have the budgetary freedom to staff the agency as they see fit and to respond quickly to emerging agency needs.

7.92 The institutional arrangements put in place as part of a framework would need to ensure that regulators were independent, but accountable to government. Within this, there are a range of structural arrangements for the regulation and oversight of financial institutions that Scotland could adopt. These can be broadly classified into four main types of regulatory structure: Institutional, Functional, Integrated and Regulation by Objective (i.e. ‘twin-peaks’). The main distinction between these structures is the approach used to allocate regulatory and supervisory tasks to different authorities.

7.93 For example, an institutional approach is one in which a regulated firm's legal status - i.e. a bank or insurance company - determines which authority is tasked with overseeing its activity. This contrasts with a regulation by objective approach where regulatory activities are grouped by the type of regulation (i.e. prudential or conduct regulation) but discharged by a single authority across the entire industry regardless of the type of financial institution.

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The Working Group acknowledge that when considering the options for a regulatory, supervisory and oversight structure appropriate for an independent Scotland, consideration should be given to the impact on financial markets, institutions and regulatory environment that already exist in Scotland.

Given the close linkages between macroeconomic stability and financial stability, and consistent with the moves toward ‘Banking Union’ in the EU, the members of the Working Group believe that it would be beneficial for supervision and oversight (e.g. microprudential regulation) to be broadly co-ordinated with other partner countries (principally the UK), irrespective of currency choice. In reality, given the inter-linkages with the UK and European financial markets the opportunities to offer a different and distinct approach are likely to be constrained and of limited benefit.

Such an approach would ensure that systemically important institutions which operated across both Scotland and the UK were regulated and supervised on a common and consistent basis. This would be in the shared interest.

There are in theory a variety of different ways through which this regulation could be delivered institutionally. For example, an independent Scottish regulator could be established with its actions and activities aligned with those of the regulator in partner countries.

In the context of a Sterling Zone framework, the Bank of England would be best placed to coordinate significant microprudential regulation. This could be discharged directly by the Bank on behalf of the Scottish Government or by a Scottish Monetary Institute working in partnership with the Bank. In a monetary union, macroprudential regulation also requires broad alignment given its increasingly important role in providing a valuable additional tool for promoting macroeconomic stability alongside monetary policy. In the context of the Sterling Zone, the Bank of England could continue its role in this regard. In time, there may be scope to consider options for spatial variation of macroprudential regulation.

With an independent currency, macroprudential regulation could be undertaken by a Scottish central bank.

Other areas of financial regulation (i.e. non-prudential elements), such as consumer protection and other conduct of business regulation, also contribute to a stable and well-
functioning financial sector. The institutional arrangements for the discharge of these functions in Scotland could also take a number of forms.

7.101 In the context of a monetary union with the UK, these functions could be discharged by a Scottish office of a Sterling Zone regulator or discharged by a separate Scottish financial regulator. Even under alternative currency options, there are likely to be benefits from a coordinated approach with key partners such as the UK and EU, which partly reflects the opportunity for firms to operate across the EEA.

7.102 Ultimately, the extent to which there is a common-rule book applied across these regulatory functions will be a key consideration when choosing the most appropriate approach for Scotland.

Crisis Management, Resolution and Deposit Protection

7.103 As highlighted in Chapter 5, in addition to supervision and regulatory issues, a successful macroeconomic framework needs to enshrine an effective crisis management, resolution and deposit protection.

7.104 An independent Scotland would need to consider carefully these arrangements given the well-developed financial services sector, links to the rest of the UK and the potential contingent liabilities to the public sector. A number of options would be available for Scotland.

7.105 Important lessons are being drawn from the financial crisis and these are shaping improvements to both crisis prevention and crisis management tools. In many countries, governments and regulators are introducing new frameworks that should be better able to respond to a developing crisis. Members of the Working Group recognise that Scotland needs to learn from these experiences, this is reflected in the preferred framework, which is set out in Chapter 9.

7.106 Serious financial crises require close coordination of monetary, fiscal and financial stability policy. The choices available to Scotland will therefore depend upon the nature of the macroeconomic regime adopted post-independence and the architecture of its institutions.
7 Monetary and Financial Stability – Design Options

7.107 New tools are now emerging to deal with the effective resolution of financial institutions at risk of insolvency. For example, the Dodd Frank Act (US) includes powers to ‘bail-in’ and a similar approach has also been set out as part of emerging EU proposals.

7.108 In the context of crisis management and resolution, a number of options would be available.

7.109 Under the option of Scotland having its own currency and monetary policy framework, the Scottish fiscal authority and central bank would be required to set up a framework to provide liquidity to financial institutions. In doing so, they could work with other central banks internationally to provide support to cross border banking groups. Scottish authorities would also require an effective resolution mechanism for failing banks. The working group members note that, given the complex structure of the financial services sector, emerging international trends, and shared self-interest, cross-border cooperation would be beneficial to both Scotland and the UK even if separate currencies were used.

7.110 In a monetary union with the UK, key design options would still exist and some would require negotiation, these include:

- the mechanism and process for central bank and public sector intervention;
- the arrangements for any burden sharing agreements between the fiscal authorities for cross-border institutions; and
- other emerging aspects of resolution – including the potential to use bail-in procedures (i.e. some of the burden of the recapitalisation placed on bond and shareholders).

7.111 The principle of such an arrangement could build upon the UK Banking Act 2009 and reflect the integrated nature of the current financial services market in the UK. This could include decisions on which resolution tools to use and referring decisions on temporary ownership to both fiscal authorities. The swift resolution of such decisions is vital and would need to be facilitated – see for example the proposed Macroeconomic Governance Committee in Chapter 9. Such an arrangement would be consistent with the motivation of a coordinated supervisory and oversight arrangement.

7.112 Irrespective of the exact arrangement – and both within a monetary union and outside – there is a growing recognition that given the increasing importance of multinational
institutions and moves to better align supervision across borders, crisis management and resolution issues should be coordinated on a supra-national basis.

7.113 In the context of Scotland this is important. Institutions which pose a systemic risk to Scotland are also integral to the entire UK system – and vice versa. The Working Group believes that the design of a framework should reflect this shared interest in financial stability. It should ensure that nation states contribute to the potential costs in a fair manner to reflect the shared benefits of financial stability.

7.114 Members of the Working Group believe that the final design for crisis management, resolution and deposit protection in an independent Scotland should take on board the trends in international coordination – see Box 7.06 for a summary of some recent developments. This is reflected in the proposal set out in Chapter 9.

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**Box 7.06: Trends in International Coordination**

International regulations are becoming increasingly important given the inter-connectedness of national economies and the global financial system. With multinational institutions and open markets, there is a growing recognition of the need to consider a common approach to financial regulation, if stability in the global economy is to be ensured.

There have been a number of developments in recent years. For example, the Financial Stability Board (FSB) set up by the G20 aims to advise and coordinate policy on a wide range of regulatory topics. Membership includes monetary authorities, regulators and supra-national institutions such as the IMF, ECB, BIS and World Bank.

In Europe, closer financial regulation is seen as pivotal to helping resolve the crisis in the Euro Area. The European Commission has recently published its vision for a Banking Union (see Box 7.04).

There is also emerging evidence of greater bilateral cross-border co-ordination. For example, the Bank of England and the US FDIC have recently set out their approaches to future crisis management, including consideration of cross-border institutions that operate in both countries.

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104 The Financial Stability Board (FSB) was set up in 2009 by the G20 to continue the work of the Financial Stability Forum (FSF) which had been created by the G7 in 1999

7.115 The final design option considered by the members of the Working Group is the arrangements for deposit protection in an independent Scotland.

7.116 An independent Scotland would be required to have in place an officially recognised scheme to provide deposit protection and investor compensation.

7.117 There are a number of approaches in place across countries in respect to the design and funding of such schemes. Box 7.07 provides a summary of existing deposit protection schemes in a number of countries. Under independence, the Scottish Government would have an opportunity to put in place a system that best reflected Scottish circumstances, and the nature of the financial services industry. It would also reflect decisions taken in other areas such as the arrangement put in place for regulation.

7.118 As a member of the EU, deposits would for example be guaranteed up to the equivalent of 100,000 Euros.

7.119 The range of international approaches to deposit protection highlights that while there is consistency around the general principle underpinning deposit protection, the institutions and mechanisms to deliver this protection can vary.

7.120 Regardless of the design option adopted in an independent Scotland, key considerations for the Scottish Government would include: the mandate or remit of the scheme; the scope of its powers; governance arrangements; funding mechanism; and coverage of the scheme.

7.121 As part of a formal monetary union, and a common approach to supervision of banks which are systemically important across the Sterling Zone, an independent Scotland could seek to establish arrangements that allow the continuation of a shared scheme across the Sterling Zone. This would be subject to negotiation. It would however, place a lower administrative burden on financial institutions, would offer economies of scale and guard against free-riding.
Box 7.07: Deposit Protection – International Context

Countries approach deposit protection in a variety of ways. Differences exist with regards to the exact responsibilities of particular schemes, as well as the mechanism through which they are funded\textsuperscript{106}.

**UK** – The Financial Services Compensation Scheme (FSCS) insures retail deposits up to £85,000. The FSCS is funded by an ex-post levy, which is collected from the financial sector depending upon the amount required each year.

**US** – The Federal Deposit Insurance Corporation is responsible for the guarantee of deposits in the US. Each retail depositor is insured to at least $250,000. The scheme is funded by premiums levied ex-ante on financial institutions. The FDIC acts as the receiver and liquidator of failed banks and other systemically important financial institutions.

**EU** – There is not yet a common EU-wide system of deposit protection, but the EU requires Member States to have one or more schemes in place to provide coverage, set at €100,000. The specific design of each scheme currently differs between Member States. However, deposit protection makes up one of the four pillars of the proposed Banking Union and there is also a clear direction of travel toward greater harmonisation of national schemes\textsuperscript{107}. It is envisaged that any new approach will be funded by ex-ante levies applied to participating institutions and that national authorities will work more closely together – including through the provision of lending and borrowing between themselves to fund potential shortfalls. The proposals also state that schemes can be merged across countries.

7.122 An independent Scotland would also have the option to establish its own scheme. As outlined in Chapter 6, there are a complex business structures in place across a number of Banks in the UK. Members of the Working Group, believe that as a result of the complex organisational structure of many of the financial institutions operating in Scotland and the UK, a joint scheme would be the more attractive option, and would be in the interests of both Scotland and the UK. However, alternatives are clearly possible and if they were to be considered would not undermine the proposals in other areas.

\textsuperscript{106}For a more complete summary of current deposit protection schemes see: Thematic Review on Deposit Insurance Systems, The Financial Stability Board, February 2012, \url{http://www.financialstabilityboard.org/publications/r_120208.pdf}

\textsuperscript{107}Directive on Deposit Guarantee Schemes, European Commission, July 2010, \url{http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_proposal_en.pdf}
7 Monetary and Financial Stability – Design Options

Conclusions

7.123 Following independence there would be an immediate choice to either be part of a monetary union or to establish a separate Scottish currency.

7.124 There are a variety of economic factors which are worthy of consideration when assessing the merits of currency options open to an independent Scotland.

7.125 The choice of currency, by dictating both the fundamental structure of the monetary framework and the relationship with other countries, will also have implications for decisions over the overall shape of the public finances and financial stability.

7.126 The international financial crisis highlighted a number of deficiencies with the existing regulatory framework in the UK and internationally with respect to overall financial stability.

7.127 One of the clear lessons of the financial crisis has been that the previous arrangements for regulation and stability were inadequate. The future design of financial regulation, crisis prevention and crisis management will increasingly need to take into account the international context, and reflect the need for cooperation between national authorities in the common interest of financial stability.

7.128 It is highly likely that – post-independence – the design of a regulatory framework would reflect the Scottish and UK common interest in financial stability. Part of this could include discussions around shared-interests in cross-border supervision of major institutions and possible intervention frameworks.
Chapter Summary

- Chapter 8 provides a summary of the design options available to an independent Scotland for a fiscal framework.
- With independence, the Scottish Parliament would be fully responsible for fiscal policy in Scotland, including the collection of tax receipts and government expenditures.
- A sound fiscal framework will be essential for a newly independent Scotland. This would be particularly true during the early years of independence, with clear benefits from demonstrating competence and fiscal sustainability.
- As part of the design of a fiscal framework under independence, the Scottish Government would have the opportunity to put in place a revised set of fiscal rules to help guide policy and ensure that Scotland’s oil and gas reserves were managed effectively.
- It is envisaged that an independent Fiscal Commission would play a key role in the drafting of these rules, monitoring them and advising the government on the best policy approaches to meet them.

Introduction

8.1 As highlighted in Chapter 5, a key element of a macroeconomic framework is a stable, flexible and credible fiscal framework. It is an essential foundation of sustainable economic growth.

8.2 At the heart of a robust fiscal framework should be a system which ensures that public sector debt and borrowing are managed and controlled effectively. Healthy public finances can encourage growth and promote private investment. In contrast, pressures on the public finances can lead to higher taxation and lower public expenditure in the medium to long-term. This can limit the opportunities to use fiscal policies to support economic growth and address inequalities.
8 Fiscal Framework – Design Options

8.3 This chapter discusses the options for a future Scottish Government in establishing a revised fiscal framework for Scotland post-independence.

8.4 A credible fiscal framework will be an important first-step for a future Scottish Government. It will be vital to gain credibility among investors.

8.5 This chapter reviews these issues. It first summarises Scotland’s fiscal position.

Affordability

8.6 The UK public finances have deteriorated significantly over recent years. While much of this reflects the impact of the global recession, it also reflects decisions taken during the late 1990s and early 2000s.

8.7 Between 2000 and 2007 UK public sector debt increased as a share of GDP despite strong economic growth.

8.8 At the same time, the underlying strength of the UK public finances also weakened significantly during this period, despite the existence of apparently tough fiscal rules. For example, in 2000 the UK ran an estimated structural budget surplus (i.e. adjusted for the economic cycle) equivalent to 2.4% of GDP. However, in subsequent years this surplus turned to deficit despite strong economic growth and the adoption of fiscal rules to guide policy. Some of this reflects persistently over optimistic forecasts by HM Treasury but also unsustainable spending commitments.

8.9 As a result, shortly before the global financial crisis began in 2007, the UK’s structural budget deficit stood at 5.2% of GDP.\(^{108}\) This was the largest structural 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 2007. The UK was therefore poorly placed to deal with the fiscal consequences of the crisis.

8.10 As a result of the recession, UK public sector net debt has risen sharply. The latest public sector finance statistics show that, at the end of October 2012, net UK public sector debt was £1,069 billion (or 67.9% of UK GDP). Net debt is forecast to peak at 79.9% of GDP in 2015/16.¹⁰⁹

8.11 The UK’s level of public indebtedness, based on an internationally comparable measure, is relatively high when compared to other OECD countries.

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8. Fiscal Framework – Design Options

<table>
<thead>
<tr>
<th>Table 8.01: General Government Gross Debt (% of GDP) to 2015</th>
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Source: IMF, World Economic Outlook Database, October 2012

8.12 Under current plans, the UK Government has announced spending cuts will continue into 2017/18 in an effort to return the public finances to a sustainable position. This means that the UK will experience eight consecutive years of spending cuts, something which is historically unprecedented.

8.13 Between 2010/11 and 2014/15, the Scottish Government’s block grant will be reduced by nearly 10% in real terms, with further cuts planned in the following three years.

Scotland’s estimated public finances

8.14 Government Expenditure and Revenue Scotland (GERS), provide estimates of Scotland’s public finances under the current constitutional framework.
8.15 The most recent edition of GERS covers the five years to 2010/11. GERS provides estimates of the total tax revenue generated from economic activity in Scotland – see Table 8.02\textsuperscript{110} and estimates of total public sector expenditure for Scotland (see Table 8.03)\textsuperscript{111}.

\begin{table}[h]
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\begin{tabular}{|l|c|c|c|c|c|}
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 & \textbf{2006-07} & \textbf{2007-08} & \textbf{2008-09} & \textbf{2009-10} & \textbf{2010-11} \\
\hline
Excluding North Sea revenue & 42,272 & 45,167 & 43,391 & 41,916 & 45,177 \\
Including North Sea revenue (per capita share) & 43,026 & 45,796 & 44,479 & 42,462 & 45,914 \\
Including North Sea revenue (geographical share) & 49,776 & 52,282 & 55,131 & 47,846 & 53,128 \\
\hline
\hline
\textbf{(\% of Total UK Revenue)} & & & & & \\
\hline
Excluding North Sea revenue & 8.3\% & 8.3\% & 8.3\% & 8.3\% & 8.3\% \\
Including North Sea revenue (per capita share) & 8.3\% & 8.3\% & 8.3\% & 8.3\% & 8.3\% \\
Including North Sea revenue (geographical share) & 9.6\% & 9.5\% & 10.3\% & 9.3\% & 9.6\% \\
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\end{tabular}
\caption{Table 8.02: Total Current Revenue: Scotland 2006-07 to 2010-11}
\end{table}

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|c|c|}
\hline
 & \textbf{2006-07} & \textbf{2007-08} & \textbf{2008-09} & \textbf{2009-10} & \textbf{2010-11} \\
\hline
Total Public Sector Expenditure for Scotland (£ millions) & 52,810 & 55,969 & 58,866 & 62,025 & 63,807 \\
Total Public Sector Expenditure for Scotland (% of UK Total) & 9.6\% & 9.6\% & 9.4\% & 9.3\% & 9.3\% \\
\hline
\end{tabular}
\caption{Table 8.03: Public Sector Total Managed Expenditure: Scotland 2006-07 to 2010-11}
\end{table}

8.16 As GERS takes the current constitutional framework as given, it is limited in what it can and cannot say about independence. Post-independence, not only will the fundamental structures of the Scottish economy (such as economic incentives and expectations) be subject to change, but the basic tax and spending choices of an independent nation may also differ. In addition, particular expenditure commitments – such as debt interest payments – may be subject to negotiation.

\textsuperscript{110}GERS provides three estimates of tax receipts for Scotland, excluding North Sea revenues; allocating a per capita share of North Sea revenues; and, allocating an illustrative geographical share of North Sea revenues. Unless otherwise stated, all the revenue figures in this report include an illustrative geographical share of North Sea revenues.

\textsuperscript{111}This includes a population share of expenditure on UK wide public services such as defence and debt interest repayments.
8 Fiscal Framework – Design Options

8.17 It does however provide a useful indication of the relative strength of the public finances under the current framework and a starting point for discussions of Scotland’s fiscal position.

Tax Revenue and Public Spending

8.18 In 2010/11, total public sector expenditure for Scotland, including a per capita share of debt interest payments, was estimated to be £63.8 billion, equivalent to 9.3% of total UK public spending.

8.19 Scotland’s total estimated tax receipts comprise both onshore tax revenue and offshore receipts. In 2010-11, onshore tax receipts in Scotland totalled £45.2 billion. This was equivalent to 8.3% of total UK onshore tax revenue, broadly in line with Scotland’s share of the UK population.

8.20 The single largest source of tax revenue is income tax, which is estimated to have generated £10.6 billion in revenue in 2010/11. VAT and National Insurance Contributions were the second and third largest sources of tax revenue, raising £8.6 billion and £8.0 billion respectively.

8.21 Devolved taxes (non-domestic rates and council tax) collectively generated approximately £3.9 billion in tax revenue - 8.6% of onshore Scottish tax receipts.

8.22 Scotland’s illustrative geographical share of offshore oil and gas revenues was estimated to be worth £8 billion in 2010-11, equivalent to 91% of total UK offshore tax revenues.\(^{112}\)

8.23 In total therefore, GERS estimates that £53.1 billion in tax revenue was raised in Scotland during 2010/11 including an illustrative geographical share of North Sea revenue. This is equivalent to 9.6% of total UK tax receipts, as illustrated in Chart 8.02 below.

\(^{112}\) Further information on the methodology used to estimate Scotland’s geographical share of North Sea oil and gas receipts is provided in Chapter four of the latest edition of Government Expenditure and Revenue Scotland: [http://www.scotland.gov.uk/gers](http://www.scotland.gov.uk/gers)
In 2010/11, Scotland’s geographical share of North Sea revenue, was equivalent to 15% of total Scottish tax revenue. In comparison, total North Sea revenues of £8.8 billion were equivalent to 1.6% of total UK tax receipts. A key long term challenge for Scotland under independence would be to manage both the volatility of these revenues and to ensure that as North Sea tax receipts decline, Scotland is able to grow its tax base to fund public spending from non-oil tax revenue.

It is worthy of note, that between 2008/09 and 2009/10 North Sea revenues fell from £12.9 billion to £6.5 billion as a result of the global recession. However, the volatility of North Sea revenues needs to be put in context. Despite this fall Scotland continued to run a smaller fiscal deficit than the UK.

GERS provides two estimates of Scotland’s overall fiscal position, the current budget balance and the net fiscal balance.

Scotland’s estimated current budget balance illustrates the difference between current revenue and current expenditure, excluding capital expenditure. The current budget balance

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Note that the estimates of Scotland’s fiscal position include an illustrative geographical share of North Sea oil and gas tax receipts.
8 Fiscal Framework – Design Options

balance measures the degree to which current taxpayers meet the cost of paying for the public services they use.

8.28 Scotland ran an estimated current budget surplus in 2006-07 and 2008-09, and small deficit in 2007-08.

8.29 However, in line with all other advanced economies, Scotland’s public finances deteriorated in 2009-10 as a result of the global recession. In 2010-11 Scotland ran an estimated current budget deficit of £6.4 billion (4.4% of GDP). This compared with the UK’s current budget deficit of £97.8 billion (6.6% of GDP) in the same year.

8.30 The net fiscal balance measures the difference between total public sector expenditure (including capital expenditure) and public sector revenue. It therefore includes the money spent investing in public sector infrastructure (i.e. roads, hospitals, and schools) which will bring benefits to the Scottish economy in the future.

8.31 Over the period 2006-07 to 2010-11 Scotland’s estimated net fiscal deficit has averaged £7.1 billion a year, equivalent to 5.1% of GDP. Again, this is proportionately smaller than the UK’s fiscal deficit which averaged £90.8 billion, a year (6.4% of GDP) over the same period.

8.32 Chart 8.03 provides a comparison of the estimated net fiscal balance for Scotland and the UK between 2006-07 and 2010-11.
8.33 The Institute for Fiscal Studies estimate that since 2000, increases in oil prices mean that, were a geographical share of oil to be included, “Scotland’s public finances are estimated to have been somewhat stronger than those of the UK: an average 1.5% versus 1.8% current budget deficit and an average 3.7% versus 3.8% net fiscal deficit.”

8.34 A number of advanced economies run small, sustainable fiscal deficits which they fund by borrowing.

8.35 The fact that Scotland is currently running a greater fiscal deficit in recent years reflects the impact of the financial crisis that has sparked a global recession. This is true for most countries.

8.36 The IMF reports that the average annual net fiscal deficit among the G7 economies was 5.6% of GDP between 2006 and 2010. This is because carefully managed government borrowing, used to fund public infrastructure, can lead to benefits in future years by increasing productivity and economic growth. Intuitively these fiscal deficits will be higher at times when economic growth is weak, such as in 2010 when the average fiscal deficit in

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8 Fiscal Framework – Design Options

the G7 was 9.0% of GDP. On an internationally comparable basis Scotland’s fiscal deficit in 2010 was 8.0% of GDP\[115\].

8.37 As highlighted above, a key difference between Scotland and the UK is the importance of North Sea revenues.

8.38 In 2010/11, Scotland’s estimated net fiscal balance, the difference between tax receipts and public spending, was a deficit of £18.6 billion (15.6% of GDP) excluding North Sea revenue, or a deficit of £10.7 billion (7.4% of GDP) including a geographical share of North Sea revenue. The equivalent UK position (i.e. ‘net borrowing’) was a deficit of £136.1 billion (9.2% of GDP).

8.39 Looking forward, the OBR forecast that the UK’s net fiscal deficit will fall from its peak of 11.2% of GDP in 2009-10 to 1.6% of GDP by 2017-18. Whilst the UK public finances are expected to return broadly to balance by this point the impact of the recession will be reflected in the UK’s fiscal position for years to come. By 2017-18 the OBR forecast that public sector net debt will have reached 77% of GDP more than double its level at the start of the financial crises in 2007. The OBR’s latest long term fiscal projections (June 2012) suggest that on current policies public sector net debt will not return to pre-crisis levels.

8.40 Scotland’s public finances are expected to follow a similar trend to the UK with its net fiscal deficit gradually declining as a share of GDP in the years to 2017-18. A key determinant of the outlook for Scotland’s public finances is future tax receipts from the oil and gas sector. These will be influenced by both future production in the North Sea and changes in global oil and gas prices, all of which are subject to a range of forecasts. For example, the OBR forecast that oil prices will fall to $92 a barrel by 2017-18, whilst the Department for Energy and Climate Change assume that prices will rise to $120 a barrel. This makes it particularly challenging to forecast the outlook for Scotland’s fiscal position.

8.41 Box 8.01 provides a summary of Scotland’s long-term fiscal position from 1980-81.

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\[115\] As the IMF does not produce figures for Scotland, the figure of Scotland is based on the ratio of UK deficit as calculated by IMF and the comparable figure for the UK as published in GERS. Therefore the 8.0% of GDP figure for 2010 is calculated differently to the GERS Net Fiscal Position illustrated in Chart 8.03 above for 2010-11.
Box 8.01: Scotland’s Long Term Fiscal Balance

The most recent editions of GERS provide estimates of Scotland’s public finances from 2006/07 to 2010/11. To accompany the publication, an experimental dataset was published providing estimates of Scotland’s public finances from 1980/81 using the GERS methodology.

Chart 8.04 shows Scotland’s estimated net fiscal balance as a percentage of GDP for each year from 1980/81 to 2010/11.

Chart 8.04: Scotland & UK – Net Fiscal Balance (% GDP)

The results show that during the early 1980s Scotland is estimated to have run a substantial net fiscal surplus, driven by North Sea revenues. Since then, while typically in deficit, the Scottish deficit has tracked the UK’s.

Between 1980/81 and 2010/11 as a whole, Scotland is estimated to have run an average annual net fiscal surplus equivalent to 0.5% of GDP. Over the same period, the UK as a whole ran an average annual net fiscal deficit worth 3.1% of GDP.

Scotland’s cumulative net fiscal balance, the cash sum of the individual annual surpluses and deficits, over the period 1980/81 to 2010/11 as a whole was a deficit of £38 billion, equivalent to 26% of Scottish GDP in 2010-11. The UK as a whole ran a cumulative net fiscal deficit of £851 billion over the same period, equivalent to 58% of GDP. Scotland’s per capita share of the UK’s deficit would have been equivalent to £71 billion (49% of GDP), almost twice as large as Scotland’s observed deficit over this period.
Scotland’s relative net fiscal balance vis-à-vis the UK naturally follows a similar pattern to that set out in Chart 8.04 above. Following a relatively strong position in the 1980s, Scotland had a relatively weaker fiscal position through most of the 1990s and early 2000s. Although Scotland returned to a position of relative strength in the late 2000s.

Fiscal Framework

8.42 The general policy principles to deliver a sustainable fiscal framework have been highlighted in Chapter 5. Some specific Scottish issues are summarised below.

8.43 It is worth noting that fiscal policy under independence would still be subject to some international rules and regulations. This would include EU directives on competition, on regulation and the EU Single Market. However, Scotland’s relationship with the international community would take place within the context of Scotland acting as an independent sovereign state.

8.44 A fiscal framework for Scotland is likely to contain a number of important elements. These include –

- Fiscal Rules & Fiscal Commission;
- A framework for managing North Sea Revenues and creating a stabilisation fund;
- Management of a share of existing UK Net Debt.

Fiscal Rules and Fiscal Commission

8.45 As highlighted above, increased decision making powers and control of policy levers also brings with it increased responsibilities and the need to use these in a fiscally sustainable way.

8.46 The Working Group has discussed as part of a wider strategy to deliver macroeconomic stability the establishment of rules which incorporate explicit debt targets and limits. This would help to ensure fiscal sustainability, while at the same time providing the flexibility for differential policy choices and flexibilities in the design of the underlying tax system and a range of specific fiscal policies suitable for Scotland. Even in a monetary union there is no
requirement, or rational in terms of macroeconomic stability, for tax harmonisation or expenditure alignment.

8.47 Under independence, the Scottish Government would have the opportunity to put in place credible fiscal rules which governed its approach to budgetary management over both the economic cycle and its longer term approach to fiscal sustainability.

8.48 Such rules would need to set out clearly the Scottish Government’s intent to manage carefully the public finances – both over the short and medium to long-term. Generally speaking there is likely to be merit in two types of rules. Firstly, one to govern the short to medium-term path of net borrowing. A rule such as only borrowing to invest over the cycle is likely to be desirable. Secondly, a rule to govern the medium to long-term limit on net debt (i.e. the overall stock of debt). The two need to be made mutually consistent.

8.49 An important consideration will be the measure of indebtedness used to assess the sustainability of the public finances. For example, the UK Government’s preferred measure, public sector net debt, excludes a number of future spending commitments by the public sector such as PFI unitary charge payments. Upon independence a Scottish Government may therefore wish to take a broader view of public sector indebtedness.

8.50 Another key consideration when evaluating the sustainability of a given level of debt is not just the overall stock, but the associated repayment costs. A future Scottish Government may wish to consider the ratio of future public spending to GDP that is pre-committed through debt interest payments. This would allow the government to borrow more during periods when borrowing costs were lower, and borrow less when the cost of doing so was high. It would also provide a broader picture of the future commitments made by Scottish Ministers and their fiscal sustainability than is offered by simply measuring the stock of public sector debt.

8.51 These measures, alongside a clear political commitment to fiscal responsibility, would help to establish Scotland’s credibility among international investors.

8.52 The Working Group is aware that Scottish Ministers have accepted the principle of establishing a Scottish Fiscal Commission to advise on fiscal policy alongside moves towards greater autonomy.
8 Fiscal Framework – Design Options

8.53 It is likely that a Fiscal Commission in an independent Scotland would have an important role to play in monitoring compliance with the country’s fiscal rules, and even potentially contributing to the design of those rules in the first place. It could also have a role in producing macroeconomic and fiscal forecasts more generally, giving independent oversight of policy costings, likely outcomes and using its analysis to underpin the fiscal policy debate.

8.54 The exact nature of any fiscal rules would be open to the newly established Scottish Parliament in a post-independent Scotland. If Scotland enters into a monetary union with the rest of the UK, it is likely that key aspects of these rules would be negotiated and agreed on an equitable basis with the rest of the UK, but in a way that would still provide fiscal flexibility. Such an agreement would likely require debt and borrowing to fall within an agreed range. As an illustrative example, in 2010-11 Scotland’s net fiscal deficit was approximately 1.8 percentage points lower than the UK’s. Under such a framework, Scotland would have had the flexibility to borrow less, increase public spending or reduce taxes.

8.55 This would ensure that both partners within a Monetary Union agreed on the joint benefits and parameters associated with overall fiscal responsibility.

Management of North Sea Oil Revenues and Creation of a Stabilisation Fund

8.56 As highlighted above, a key difference between the public finances of Scotland and the UK is the contribution to tax receipts made by North Sea oil revenues.

8.57 Oil and Gas UK’s 2012 Economic Report\(^\text{116}\) estimates that up to 24 billion barrels of oil equivalent have still to be extracted. The Scottish Government estimates that these reserves have a potential wholesale value of £1.5 trillion. This implies that, by value, more than half of oil and gas reserves have still to be recovered.

8.58 Effective management of these revenues will be key to the long-term sustainability of Scotland’s public finances. For the UK, North Sea revenue accounts for approximately 1.5%

of total tax revenue. For an independent Scotland, the North Sea would instead account for approximately 15% of its tax receipts. This represents a significant source of revenue, however it is smaller than the proportion of revenue that many oil and gas producers receive from their natural resources. For example, oil and gas receipts have accounted for approximately 31% of public sector revenue in Norway over the past five years\textsuperscript{117}.

### Box 8.02: Impact of Changes in Oil Prices

A key difference between the Scottish and UK public finances is the manner in which they respond to changes in oil and gas prices.

Analysis by the OBR\textsuperscript{118} estimates that for the UK, higher oil prices would increase government borrowing. They found that for the UK, the increase in North Sea receipts would be more than offset by other economic and fiscal effects. These effects include:

- Lower fuel duty from less fuel consumption.
- Higher energy costs leading to an increase in prices, which would feed through to increased spending on those benefits and other social transfers that are indexed to inflation.
- A reduction in economic activity leading to an indirect effect on many areas of government spending and revenue.

The OBR estimated that a temporary increase in the oil price of £10 would increase North Sea oil revenues by £2.4 billion over 2 years. However, they found that this would be more than offset by the other effects listed above, leading to a net increase in UK Government borrowing of £0.6 billion.

The OBR’s analysis can be replicated for Scotland. As oil and gas production accounts for a larger share of Scottish tax receipts, the direct effect of a change in the oil price is relatively greater. This analysis shows that a temporary increase of £10 to the oil price would increase Scottish North Sea oil revenues by an estimated £2.2 billion. Whilst there are estimated to be offsetting reductions in other taxes these are of a relatively smaller magnitude. Consequently, the net impact on Scottish public finances would be to reduce borrowing by an estimated £1.9 billion over two years.

Differences in the relative exposure of the Scottish and UK public finances to changes in oil prices means that overall fiscal balances have tended to diverge year on year. Chart 8.05 shows UK and


\textsuperscript{118} Assessment of the Effects of Oil Price Fluctuations on the Public Finances, OBR, September 2010
Scottish net fiscal balances expressed as deviations from trend. These divergences are greater than for other macroeconomic variables (see accompanying Annex).

Chart 8.05: Standard deviations from trend in Net Fiscal Balance including a geographic share of North Sea Oil revenue

8.59 North Sea receipts have historically been more volatile than onshore tax revenue, forecasts of future revenue are also subject to larger margins of error than many onshore tax receipts. In addition, unlike other sources of a nation’s wealth, oil and gas reserves are non-renewable. By its very nature, once a barrel of oil has been produced, it cannot be reproduced in the future. To a certain extent, current production levels can be maintained by exploring for, discovering and developing new reserves, but ultimately, a point will be reached when all oil reserves have been exhausted. The fiscal rules of an independent Scotland will have to reflect the need to carefully manage this windfall to ensure that the benefit it brings to the Scottish economy is maximised.

8.60 In principle, the Working Group sees clear merit in investing at least a proportion of the receipts from North Sea revenues into an Oil Fund to invest for future generations. This would ensure that a share of the wealth generated from oil production is transferred to a separate fiscal account where it can be saved and invested over the long-term. This is the approach which has been adopted in Norway. The Norwegian government has transferred

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its surplus revenue from the oil and gas industry to an oil fund since 1996. Now worth £400 billion\(^{120}\) (equivalent to £80,000 per person in Norway), it is the largest Sovereign Wealth Fund in the world.

8.61 However, as outlined above, Scotland is currently running a budget deficit. In the near term it would therefore have to use North Sea revenues to fund current public services and reduce public sector borrowing. As explained below, this does not negate the concept of a stabilisation fund.

8.62 A long-run objective should still be to achieve as close to an overall onshore budget balance, and to use at least a proportion of North Sea revenues to invest for the long-term. In the short-run, there is also an argument in favour of establishing some form of mechanism to set up a stabilisation fund even if there is borrowing. Such a fund could be used to smooth expenditure and borrowing during economic shocks as outlined in Box 8.03. This would provide real practical benefits and demonstrate a commitment by the Scottish Government to fiscal responsibility and sustainability.

**Box 8.03: Scottish Stabilisation Fund**

An independent Scotland will need to establish its credibility on international financial markets to minimise its borrowing costs. This could be achieved by adopting a strategy for reducing public sector debt, and by adopting an effective budget constraint for the public finances.

Alongside this, given volatility in oil revenues and the possibility that they will be subject to both upside and downside risks, there is clear merit in establishing a stabilisation fund. This could provide a liquid source of funding to help support the Scottish public finances and economy if needed and ensure any ‘windfall’ receipts were saved rather than used to fund current expenditure.

This approach would help ensure predictability in the budget process and in the setting of policies and spending programmes. It would be particularly important for Scotland within the context of a monetary union in that it would provide a useful policy lever to mitigate the impact of any asymmetric shock while still remaining within overall parameters for fiscal responsibility.

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\(^{120}\) National Budget 2012, Norwegian Ministry of Finance, May 2012
There are a number of ways in which resources could be transferred to a stabilisation fund. As outlined above, in the longer term, Scotland should aim to achieve an overall onshore budget balance. This would allow all oil and gas receipts to be saved in an oil fund. This is similar to the approach adopted in Norway.

Adopting this strategy historically would have allowed the Scottish Government to establish a significant asset base. For example, if the Scottish Government had the opportunity to invest the net fiscal surpluses achieved since 1980 it could have accumulated assets equivalent to between 62% and 84% of GDP. As Scotland is currently running a net fiscal deficit, opportunities to apply this investment strategy are likely to be limited in the years immediately following independence, although it should remain a key medium term objective.

An attractive approach in the short-term would be to plan the government’s spending plans on the basis of a cautious forecast of oil revenues produced by an independent fiscal commission. Then, if oil revenues exceed the forecasts, the excess could be transferred into a stabilisation fund.

Such an approach would ensure that the public finances were not unduly exposed to volatile movements in oil revenues. It would also ensure that transfers into the oil fund did not come at the expense of planned funding for current public services. Ideally, this approach requires a country’s public finances to be in surplus so that transfers into the fund are not funded by debt. However, in principle a country could transfer resources to an oil fund based on this approach whilst being in deficit.

A related approach would be to allocate a fixed proportion of oil and gas revenues to the oil fund each year, irrespective of the government’s wider fiscal position. For example, in Alaska, 25% of revenues from the auction of new leases and state mineral royalties are automatically transferred into the Alaska Permanent Fund.

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121 This result is derived from the long term GERS analysis referred to in Box 8.01. Two extensions are made to the analysis. Firstly, the annual debt interest payment assigned to Scotland is linked to the estimated level of Scottish public sector debt, rather than being a constant population share of UK debt interest. Secondly, it is assumed that in years when Scotland runs a net fiscal surplus, the surplus is transferred to an investment fund. The investment fund’s assets are assumed to generate a constant real return of 2% in the first scenario and 3% a year in the second scenario. By 2010 it is estimated that there assets would be worth 62% of GDP under scenario one and 84% of GDP under scenario 2.
Management of a share of Public Sector Net Debt

8.63 Upon independence, the Scottish Government is expected to inherit a share of UK public sector debt. In 2015-16, UK public sector debt is forecast to peak at 80% of GDP, equivalent to almost £1.5 trillion – the highest since the 1960s.

8.64 Interest payments are forecast to represent a rising proportion of total UK public spending. This is outlined in Table 8.04.

<table>
<thead>
<tr>
<th>Table 8.04: UK Public Sector Net Debt</th>
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<tr>
<td>UK net debt (£Bn)</td>
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<tr>
<td>UK net debt (%GDP)</td>
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<tr>
<td>Debt Interest Payments (£Bn)</td>
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<tr>
<td>Debt interest payments (% of public spending)</td>
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</tbody>
</table>

Source: OBR – Economic and Fiscal Outlook December 2012 and March 2012

8.65 The proportion of this debt which would be taken on by Scotland post-independence would be subject to negotiation. The Scottish Government should seek to negotiate a fair and equitable share of UK public sector liabilities and assets. One would expect that if Scotland was to bear a proportional burden of historic liabilities that it would receive a corresponding share of both tangible and non-tangible assets.

8.66 There are complex legal issues surrounding existing UK Government debt, particularly around the definition of ‘successor state’ and the transfer of debt between borrowers without obtaining the approval of the creditors.

Allocation of national debt

8.67 There are no agreed international rules on the division of assets and liabilities in the context of state succession or independence and there is also a lack of clear precedent or consensus. In practice the position on sharing the national debt is likely to be governed by
8 Fiscal Framework – Design Options

political rather than legal considerations. Any final agreement would form part of wider negotiations on the division of assets and liabilities of the UK State.

8.68 As an illustrative example, if Scotland assumed a population share of UK public sector net debt in 2017-18, it would be estimated to be worth £126 billion, which would be equivalent to 72% of Scottish GDP. This would be slightly lower than the equivalent UK figure of 77%.

Box 8.04: Vienna Convention (1983)

There are provisions on the treatment of transfer of national debt in the 1983 Vienna Convention on Succession of States in respect of State Property, Archives and Debts.

Article 38 states that ‘When the successor State is a newly independent State, no State debt of the predecessor State shall pass to the newly independent State, unless an agreement between them provides otherwise’.

A ‘newly independent State’ means a successor State the territory of which, immediately before the date of the succession of States, was a dependent territory for the international relations of which the predecessor State was responsible.

Article 40 of the Convention covers the separation of part or parts of the territory of a State. It states that ‘when part or parts of the territory of a State separate from that State and form a State, and unless the predecessor State and the successor State otherwise agree, the State debt of the predecessor State shall pass to the successor State in an equitable proportion, taking into account, in particular, the property, rights and interests which pass to the successor State in relation to that State debt’.

The convention has yet to be ratified, including by the UK.

8.69 Table 8.05 provides estimates of what Scotland’s population share of UK net debt, and debt interest payments would be in the years from 2010-11 to 2017-18 based on Scottish and UK population projections published by the National Records of Scotland and the ONS. By 2017-18, Scotland’s population share of UK net debt would be £126 billion, with annual debt interest payments of approximately £5.7 billion.
8.70 An alternative way to determine Scotland’s share of UK public sector debt could be to base the calculation on an estimate of Scotland’s historic contribution to the UK’s public finances.

<table>
<thead>
<tr>
<th>Table 8.05: Scotland’s Population Share of UK Public Sector Net Debt</th>
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<tbody>
<tr>
<td><strong>Net debt as % of GDP</strong></td>
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<tr>
<td>Scotland</td>
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<tr>
<td>UK</td>
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<tr>
<td><strong>Debt interest payments as a % of total spending</strong></td>
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<tr>
<td>Scotland</td>
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<tr>
<td>UK</td>
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</tbody>
</table>

Source: Scottish Government analysis, OBR – Economic and Fiscal Outlook December 2012 and March 2012

8.71 Estimates of Scottish tax receipts and public spending, based on the GERS methodology, have only been produced for the period 1980-81 to 2010-11. As approximately 87% of the UK debt accrued by 2010-11 was issued since April 1980, this time period gives a broad indication of the amount of debt that, it could be argued, has been accumulated for the ‘benefit’ of Scotland.122

8.72 Using this methodology, Scotland’s estimated cumulative net fiscal deficit (the difference between tax revenue and public spending) including a geographical share of North Sea production between 1980-81 and 2010-11 is estimated to be £38 billion. This equates to 4.5% of the cumulative UK deficit over the same period.

8.73 Applying this ratio to UK public sector net debt in 2010-11 would imply that Scotland’s estimated share of UK debt would be worth £40.6 billion. This is equivalent to approximately 27.6% of Scottish GDP (including North Sea oil), lower than the population share calculated above in Table 8.05.

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122 It should be noted that these figures are estimates based on proxy measures of Scottish tax receipts and public spending, rather than actual data sources
Scotland’s estimated share of UK debt interest payments in 2010-11 based on this methodology would be approximately £2.0 billion, equivalent to 3.1% of Scottish public spending (lower than the per capita share in Table 8.05).

**Box 8.05: Transferring Debt to Scotland Post-independence**

Post-independence, there are, in theory, a number of hypothetical options for managing and servicing Scotland’s national debt.

Three options, based upon the assumption of Scotland inheriting a share of debt, include –

- Transfer of a proportion of UK gilts to the Scottish Government immediately post-independence;
- Transition mechanism in which the Scottish Government pays an agreed share of debt interest on outstanding debt until maturity then repays the principal (with any new debt issued separately by the Scottish Government); and,
- Transition mechanism as above followed by issue of Sterling Bonds (i.e. jointly issued by both governments).

The first option would allow for an immediate division of debt and avoid lengthy transition arrangements. However, this may require a change of legal entity in existing contracts or the issue of new Scottish gilts to replace pre-existing UK gilts. There are complex questions surrounding the legality of transferring debt between borrowers without obtaining the approval of the creditors.

The second option would mean that the Scottish Government would gradually assume its own debt through refinancing the agreed share of the original UK debt stock. There would be a corresponding reduction in transfers to the UK for interest payments as the gilts ‘rolled-over’ onto Scotland’s books. In theory, the initial legacy debt servicing payments could be arranged through a bi-lateral arrangement (e.g. a loan) between the Scottish and UK governments.

A final option would be a similar transition mechanism in which the Scottish Government pays a share of coupon payments on outstanding legacy debt to the UK. When the gilts mature, they could be refinanced by new Sterling-bonds\(^{123}\) which would be jointly issued and guaranteed by the UK and Scottish Governments.

\(^{123}\) Debt could be issued on behalf of, and guaranteed by the countries in the monetary union
Alongside calculation of the likely impact on any share of UK public finances, there are a number of practical issues to be considered with the transfer of debt to Scotland post-independence. Box 8.05 discusses some of these issues.

Most countries have a strategy of maintaining a diverse and balanced debt profile, both in terms of the maturity spectrum and the real and nominal exposure across the maturity spectrum. This avoids the need to continuously roll-over high levels of debt and debt maturities that are concentrated in particular years.

The profile of the outstanding UK debt is shown in the chart below, and illustrates the diverse spread of maturities with a significant part of the debt stock not due for redemption until after 15 years. This profile helps to identify the speed and scale any notional Scottish debt would require to be repaid or refinanced if an arrangement was put in place to service existing debt rather than immediately re-issue a Scottish share.

**Chart 8.06: UK Gilt Market Composition, 2011-12**

Source: UK Debt Management Office

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125 [www.dmo.gov.uk](http://www.dmo.gov.uk)
8 Fiscal Framework – Design Options

8.78 To manage its debt, an independent Scotland would require something akin to a debt management agency.

8.79 The typical core functions of an agency include:

- Borrowing on behalf of the government to manage liquidity / cash management;
- Strategic fund management of the debt and bond profile / delivery of debt management strategy;
- Minimising the interest paid on the national debt;
- Creating products for market; and,
- Audit / reporting against targets.

8.80 The exact functions of the Scottish debt management agency would be closely linked to the Scottish Treasury. Any debt management agency is also likely to play a critical role in managing day-to-day cash-flow and therefore has a close interaction and working relationship with the central bank, revenue agency and treasury.

8.81 In the UK, the Debt Management Office (DMO) is legally part of HM Treasury but operates as an executive agency. In other countries, alternative models have been adopted. In Ireland for example, the National Treasury Management Agency (NTMA) acts as an arms-length commercial organisation that reports to the Minister of Finance. In New Zealand the Debt Management Agency is, in essence, a Treasury department.

Fiscal Sustainability

8.82 Even assuming a per capita share of debt, whilst an independent Scotland would have a lower debt to GDP ratio than the UK it would still remain relatively high by both international and historical standards. A key objective for Scotland will be managing this level of indebtedness down. This will be a challenge for Scotland whether it is independent or not. The essential difference is that with independence, it would be up to the Scottish Government and Scottish Parliament to decide how best to manage this and to do so in the interests of the people of Scotland.
An on-going challenge of fiscal policy is the need to balance demands on public spending and taxation alongside the long run sustainability of the public finances, and to ensure that the government can meet its long-term commitments. The long-term sustainability of the public finances can be influenced by a number of factors such as changes in the size and composition of the population and tax base, alongside changes in the cost of delivering public services.

As highlighted in Chapter 4, many advanced economies face long-term demographic pressures as a result of their post-war generation retiring. This trend will increase dependency ratios with a reduction in the number of working age adults relative to the retired population. This trend is expected to reduce the ratio of tax revenues to GDP, whilst simultaneously increasing the demand for public services and therefore the level of public spending.

The OBR has published long-term forecasts for UK public spending and tax receipts on the basis of current government policy which take into account future demographic change. They find that, in the absence of policy changes, the UK’s ageing population will put increasing pressure on public services and that “on current policy we would expect the budget deficit to widen sufficiently over the long-term to put public sector net debt on a continuously rising trajectory as a share of national income. This is clearly unsustainable.”

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An independent Scotland would not be immune to these pressures. It faces similar demographic challenges to the UK as a whole and will also have to manage the projected long-term decline in North Sea production and tax receipts. An independent Scotland, however, would have greater flexibility to respond to these pressures than it currently does as part of the UK. For example, it could enhance the North Sea fiscal regime to place a greater emphasis on maximising recovery rates and ensure that the long-term value is secured from the asset. It could also put in place targeted population policies which made Scotland an even more attractive destination for highly skilled migrants. It would also be responsible for its role in the performance of the Scottish economy and would have the full range of spending at its disposal to decide on priorities (e.g. defence, welfare spending etc).

Conclusions

Under independence the Scottish Parliament would be responsible for managing all of Scotland’s public finances. It would therefore have to establish a fiscal framework which ensured that Scotland’s public sector debt and annual borrowing were kept at manageable levels, and that the government’s long term public spending and tax policies were consistent with these objectives.
8.88 Public policies have an important role to play in boosting sustainable economic growth. Investments in capital, both physical and human, and innovation are essential drivers of Scottish productivity, competitiveness and sustainable economic growth.

8.89 At the same time, independence would provide the Scottish Government with the ability to better tailor a range of policies to the unique needs of the Scottish economy and to boost sustainable economic growth and tackle inequalities. With access to the full range of fiscal levers, policymakers could take advantage of synergies that cannot currently be achieved when some aspects of policy are determined at the UK level.

8.90 The Scottish government could make a number of decisions, including on forward-looking policies which contributed to the long-term competitiveness and short-run responsiveness of the Scottish economy. These could include the creation of a stabilisation fund, to smooth the effects of volatile North Sea oil receipts and asymmetric shocks, and the appointment of an independent Fiscal Commission to encourage fiscal sustainability.
8 Fiscal Framework – Design Options
Chapter Summary

• This chapter provides a discussion of the proposed macroeconomic framework for Scotland post-independence. It offers an emerging framework to begin addressing the recommendations set out in Chapter 2. The proposal sets out key principles for the design of a successful framework, but also allows for flexibility on the exact details of how it could be delivered in practice.

• It takes the status quo as a starting point, and is designed to be robust, flexible and attractive to key partners in the rest of the UK and the EU.

• Ultimately the exact framework will be subject to negotiation, and many of these discussions may not take place until after the referendum.

• The Working Group believes, post-independence, it would be in the clear economic interests – for trade, competitiveness and financial stability – for the UK to respond positively to the overall structure of the framework proposed.

• The framework outlined for monetary policy, financial stability and fiscal policy offers fully engineered solutions to some of the challenges that have been highlighted with monetary unions – and particularly in the Euro Area.

• The framework would represent a substantial step-change in the economic responsibilities of the Scottish Parliament and greatly increase the levers at the disposal of policymakers in Scotland.

• The framework is also designed to be flexible and able to evolve should the people of Scotland wish for reform in the future or should economic conditions change post-independence. This is a key aspect of restoring economic sovereignty.
9 Macroeconomic Framework For Scotland

Introduction

9.1 This chapter sets out the broad structure of the proposed macroeconomic framework for Scotland post-independence. It builds on the technical discussion and review of the evidence and experiences of other countries set out in Chapters 5 to 8.

9.2 Scottish Ministers have stated their commitment to retaining Sterling. As highlighted in Chapter 7, the choice of retaining Sterling and seeking to negotiate a monetary union with the rest of the UK reflects a number of factors.

9.3 As the Scottish economy represents a significant share of the UK economy (nearly 10%), and there exists a significant degree of cross-border trade in goods and services, the Working Group believes that, post-independence, retention of Sterling would be in the interests of both Scotland and the rest of the UK.

9.4 The exact details and terms of the framework would be agreed by negotiation, post-referendum. However, the proposition put forward is designed to be practical, realistic and attractive to key partners within the monetary union, international capital markets and the EU. With the right structures in place, the Working Group believes that this would be an attractive and credible option for both the Scottish and UK Governments post-independence.

9.5 The framework aims to combine monetary and financial stability with the use of economic and fiscal levers to provide opportunities to grow the Scottish economy and to tackle key economic and social inequalities.

9.6 As highlighted throughout the report, the proposals have drawn on the emerging lessons from both the experiences of the recent Euro Area crisis and the global financial crisis.

9.7 As with other successful macroeconomic frameworks, the system aims to be sufficiently flexible to evolve in response to new economic developments and future preferences in the decades ahead. A key aspect of this is the gradual establishment of relevant macroeconomic institutions in Scotland.

9.8 Box 9.01 provides a summary of the proposed framework and the rest of this chapter provides further discussion on its key elements.
Box 9.01: Overview - Macroeconomic Framework of an Independent Scotland

Monetary Policy

- Formal monetary union with UK, with Bank of England (the Bank) as central bank.
- Ownership and governance of the Bank undertaken on an explicit shared basis, reflecting Scotland’s current implicit share of existing assets.
- Monetary policy set according to economic conditions across Sterling Zone.
- The Scottish Government to input into appointment process to key positions within Bank of England (for example, MPC and FPC), its remit and objectives.
- Representative from Scottish Treasury attends MPC meetings in similar capacity to existing HM Treasury representative (i.e. in a non-voting capacity).
- Matters of collective decision making on governance addressed within an overarching agreement between both governments. An institutional arrangement, a ‘Macroeconomic Governance Committee’, to be established.

Financial Stability

- Objective of the Scottish Government must be to promote financial stability and ensure that tax-payers are never again forced to step-in and bail-out private institutions.
- The proposition centres on two key aspects of financial stability from a macroeconomic perspective -
  - Supervision and Oversight; and
  - Crisis Management, Resolution and Deposit Guarantee.

Supervision and Oversight

- Scotland to establish one (or more) independent competent authorities to oversee financial regulation.
- Given the close linkages between macroeconomic stability and financial stability, key elements of prudential regulation (micro and macro) to be discharged on a consistent basis across the Sterling Zone.
- Other areas of financial regulation (i.e. non-prudential elements), such as consumer protection, form a linked, though distinct, aspect of the regulatory environment. These could be discharged in Scotland, however a degree of consistency across the Sterling Zone is likely to be desirable, given the integrated financial services sector and links to prudential regulation.
9 Macroeconomic Framework For Scotland

Crisis Management, Resolution and Deposit Guarantee

- Financial crises require close coordination of monetary, fiscal and macroprudential policy.
- Issues of financial stability – including lender of last resort facilities for financial institutions – and crisis management to be coordinated on a pan-Sterling Zone basis.
- If and when any input was required from a fiscal authority – for example an indemnity – this could be coordinated through the ‘Macroeconomic Governance Committee’.
- This could be discharged by both governments in accordance with the shareholder framework set out above.

Fiscal Policy

- Fiscal policy (along with other economic policies such as regulation) provides the principle new levers to grow the economy and to tackle key challenges in Scottish society.
- Negotiation of fair and equitable share of UK public sector liabilities and assets. A transitional arrangement whereby outstanding debt was gradually transferred to both governments would be a sensible and efficient solution.
- To promote stability within the proposed monetary union, there is merit in devising a ‘fiscal sustainability agreement’. This should cover both governments and be credible. This would not cover individual taxes and/or spending but overall net borrowing and debt. This would provide the flexibility to develop policies to promote growth and maintain economic performance.
- Given the importance of oil and gas revenues, a stability fund should be established, with the government planning budgets on a cautious estimate for oil revenues and then investing any upside variability in a fund to guard against future unexpected falls in revenue or asymmetric shocks.
- Fiscal Commission to be established, with an advisory role.
- The Scottish Government should establish an independent Scottish Monetary Institute and would be responsible for setting its remit.
- This Institute could take responsibility for a number of key functions, which it could undertake independently, including research, monitoring developments in the financial sector and data collection. It would work closely with the Bank.
- Merit in placing key macroeconomic functions, such as designated financial regulator, in such an independent body. Would also be a key focal point and reporting body for EU-wide institutions and structures and other international organisations.
**Principles**

9.9 The development of this framework has been taken forward in the context of two clear overarching objectives for the design of an overall macroeconomic framework:

- **long-term competitiveness** – maximising opportunities to raise productivity, competitiveness and economic growth over the long term; and
- **short-run responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

9.10 As set out in Chapter 5, to deliver on these objectives, the work of the Fiscal Commission Working Group has been shaped around four key themes: Credibility, Sustainability, Stability and Autonomy.

9.11 A central underpinning is the commitment by the Scottish Government to remain an active participant in the European Union (EU) – see Box 9.03 at end of this chapter for a discussion. The Working Group notes the government has made clear that Scotland’s transition to full membership of the EU will be negotiated from a position within the EU.

9.12 The outcome of these negotiations will have implications for the final specification of the framework, however the overall proposal is designed to be sufficiently flexible to meet the evolving obligations and requirements of EU membership. The starting point is the existing requirements for membership placed on the UK.

9.13 However, the exact framework can be modified to ensure that all likely EU requirements are met, including any reporting requirements, should these change or opinion differ.

9.14 Discussion of the framework is centred upon three key pillars:

- **Monetary Policy** – including the choice of currency and the framework for setting interest rates and the money supply to promote (‘price’) stability and minimise short-term volatility;
- **Financial Stability** – including the use of prudential regulation, supervision, resolution tools and deposit protection to ensure stability in the financial system; and
9 Macroeconomic Framework For Scotland

- **Fiscal Policy** – including the setting of taxes, government spending and borrowing within an overarching framework of fiscal sustainability.

**Monetary Policy**

9.15 The choice of currency is a key determinant of the overall macroeconomic framework.

9.16 Analysis shows that it would be in Scotland’s interests to retain Sterling immediately post-independence.

9.17 Scotland’s economy is strong enough and sufficiently aligned with the rest of the UK that a separate currency would not be necessary. It would also preserve the integrated market across the UK and allow for the continuation of trade *to and from* the rest of the UK. Retaining Sterling would be of benefit to both countries.

9.18 The core proposition is for Scotland to enter a formal monetary union with the rest of the UK with the Bank of England (the Bank) operating as the central bank.

9.19 Monetary policy would be set according to economic conditions in both Scotland and the UK (i.e. the ‘Sterling Zone’) – in the same way as is currently the case. In addition, other key functions undertaken by the central bank would continue to be undertaken across the Sterling Zone. One advantage of this framework is that the existing payments and settlements infrastructure could continue to operate in its current form, and the Bank of England could continue to function as a settlement agent for financial institutions across the Sterling Zone, helping to support an efficient financial system.

9.20 Ownership of the Bank could be undertaken on an explicit shared basis, reflecting Scotland’s current implicit share of existing Bank of England assets. This arrangement would be subject to agreement with the UK Government, however a practical arrangement with shareholder rights allocated on a per capita, GDP basis, or weighted by a combination of the two (as is currently the case with the European Central Bank) would seem appropriate.

9.21 The Bank would remain operationally independent to set day-to-day monetary policy.
This would involve little change in the day-to-day operations of the Bank or in its discharge of monetary policy. The Bank’s balance sheet would remain unified, albeit indemnified by two fiscal authorities. As a UK institution, the Bank would typically be part of the assets and liabilities which would be negotiated as part of post-independence negotiations.

The framework proposes that the Scottish Government should seek input into the appointment process to key positions within the Bank (for example the Monetary Policy Committee and Financial Policy Committee) and an input into its remit and objectives. A representative from the Scottish Treasury should attend MPC meetings in a similar capacity to the existing HM Treasury representative (i.e. in a non-voting capacity and to ensure that monetary policymakers were fully informed of developments in Scottish Government economic and fiscal policy).

Related to this, and as an explicit shareholder of the Bank, the Scottish Government and Scottish Parliament should seek a role in providing oversight of the Bank and its activities. This would create an appropriate system of accountability and representation for both governments.

Matters of collective decision making on governance and accountability could be addressed within an overarching agreement between both governments on the functioning of the Sterling Zone. An institutional arrangement, such as a ‘Macroeconomic Governance Committee’, should be established to oversee matters which require coordinated input and/or agreement from the respective governments. This practical arrangement could cover more than monetary policy – issues of shared interest in fiscal policy and financial stability could also be included within its remit. This institution could also provide a forum for knowledge transfer.

Such an institution could be an effective vehicle to support coordinated action where needed. A recent example of such coordinated action – within the context of the current arrangements – is the ‘Funding for Lending Scheme’. Under the proposed framework, such activity would continue on a Sterling Zone basis but with input from both fiscal authorities into the design, implementation and oversight arrangements.
Box 9.02: Why a Monetary Union would work

It has been argued that it would not be in either Scotland or the UK’s interests to form a currency union post-independence, as the experience of the Euro crisis has highlighted a fundamental weakness with any such union.

There are a number of reasons why the Working Group believes that the framework would represent a workable proposal at the outset.

- Scotland and the UK have been part of a monetary union for over 300 years. This brings a degree of economic integration, trade and factor mobility that has yet to fully develop in the Euro Area.
- The macroeconomies of Scotland and the UK share similar structures (for example, Scotland and the UK have similar levels of productivity, household wealth, while the industrial composition of the two economies is also similar).
- The economic cycles are broadly aligned.
- Scotland and the UK also share similar institutional structures (e.g. broadly similar levels of labour market flexibility, capital market openness and investment flows).
- The framework proposed and outlined in this chapter is much richer and more strongly engineered than the original Euro Area model. It proposes greater alignment of financial stability policy and mechanisms to ensure fiscal discipline.
- The framework would provide a model which would work immediately from day one, minimise uncertainty and provide for the continued co-operation and negotiation of both Government’s post-independence.

9.27 Finally, within the context of fulfilling long-term international obligations and reporting requirements, it is envisaged that the Bank of England would continue as Scotland’s central bank. However, any specific requirements could be met as part of the design of Scottish specific institutions – for example, the creation of a Scottish Monetary Institute.

9.28 This institute would take responsibility for a number of key functions, including research into the Scottish economy, monitoring of developments in the financial sector and data collection. It would work closely with the Bank of England. There may also be merit in placing key macroeconomic functions, such as responsibility for aspects of financial services regulation, in such an independent body.
Financial Stability

9.29 As highlighted throughout this report, a distinction can be drawn between financial regulation which is directly relevant to the design of the macroeconomic framework and other aspects of regulation. These are:

- Assessing and reducing risks across the financial system – macroprudential regulation and microprudential regulation of individual firms. The following sections therefore, include further discussion on both forms of prudential regulation and their critical role in delivering financial stability.

- Other areas of financial regulation which relate to the way in which financial firms interact with each other, consumers and businesses, is a linked, though distinct, element of the financial system.

9.30 The crisis of 2008 has highlighted, perhaps more clearly than ever before, the importance of financial stability and the potential damaging effects on the real economy from financial crises.

9.31 The failure of regulatory authorities and governments – particularly in countries such as the UK – to fully appreciate or identify the emerging risks in the financial sector directly led to the sharpest economic downturn since the 1930s.

9.32 This experience also highlighted a weakness in recognising and monitoring systemic risks and effectively delivering stability of the financial system. In response, policy makers across the world are actively reappraising the frameworks and institutions needed to monitor financial stability and reduce the probability and scale of future crises. A particular challenge in the increasingly connected global economy is the existence of large multinational financial conglomerates and groups with complex cross-border structures.

9.33 This is an area of on-going reform. For example, the UK Parliament passed the Financial Services Act in 2012, which will completely overhaul the system of financial regulation in the UK. As part of this, the Bank of England will regain much greater authority and autonomy for financial stability. In Europe, the first stages of a Banking Union are being designed and implemented.
9.34 It is therefore essential that any proposed macroeconomic framework for Scotland takes into consideration these reforms and is sufficiently flexible to be able to respond to these emerging developments. Indeed it is highly likely that by 2014, the landscape for financial stability – and in particular, the degree of cross-border cooperation – will have changed dramatically.

9.35 There are a number of major financial institutions which are incorporated in Scotland – but with significant business functions located elsewhere in the UK (i.e. London) – that are integral to the overall stability of the UK financial system. Similarly there are a number of major UK based financial companies with substantial presence in Scotland. In addition, a number of Banking Groups have a number of complex business structures in place across the UK. The framework takes this into account and the merits for financial stability – in both countries – of a coordinated approach.

9.36 The overarching objective of the Scottish Government must be to promote financial stability and ensure that the economy and tax-payers are never again forced to step-in and bail-out private institutions. Both Scotland and the UK have a shared interest in ensuring financial stability, and therefore a common approach should underpin the design of the framework.

9.37 With this in mind, the principles behind the emerging frameworks in both Europe and the UK are to be welcomed.

9.38 The proposition has been developed around two key aspects of financial stability from a macroeconomic perspective:

- Supervision and Oversight – proactively pre-empt any instability in financial institutions, the sector as a whole, or instability in the wider economy caused by the actions of the financial sector (e.g. a housing bubble); and

- Crisis Management, Resolution and Deposit Protection – a framework for quick and efficient solutions to crises and ensure confidence in the financial system.
Supervision and Oversight

9.39 In order to meet financial supervisory and regulatory roles, EU Member States are required to designate one or more independent competent authorities to oversee financial regulation. There are a number of institutional structures and arrangements that Scotland could adopt to achieve this.

9.40 Given the close linkages between macroeconomic stability and financial stability, and consistent with the moves toward Banking Union in the EU, the proposition is for key elements of prudential financial regulation (both micro and macro) to be discharged on a consistent basis across the Sterling Zone\textsuperscript{127}.

9.41 This would ensure that systemically important institutions which currently operate across the Sterling Zone were regulated and supervised (i.e. micro prudential regulation) on a common and consistent basis. This could be discharged either by the Bank on behalf of the Scottish regulator or by a Scottish Monetary Institute (see below) working in partnership with the Bank.

9.42 Macroprudential regulation would also be aligned and thus provide an additional tool for promoting macroeconomic stability alongside monetary policy. As this is a new and emerging area of responsibility, there may be scope in the years ahead to explore opportunities for spatial variation of such policy within the Sterling Zone.

9.43 It is widely recognised that there are benefits from assigning responsibility for significant prudential regulation to central banks. With the Bank of England assuming the role in the years ahead, and with the framework proposing that monetary policy continues to be discharged by the Bank, this would also help ensure that prudential regulation was consistent with the functions of the Bank.

9.44 Other areas of financial regulation (i.e. non-prudential elements), such as consumer protection and other ‘conduct’ aspects, form a linked, though distinct, aspect of the regulatory environment. These could be discharged in Scotland. There would however, be

\textsuperscript{127} The European Commission have, for example, recently proposed moves towards a Single Supervisory Mechanism which includes an enhanced role for the ECB in relation to supervisory tasks for financial stability and prudential banking supervision. The ECB will now act as supervisor for major Euro Area banks and a common rulebook will also be applied.
merit in ensuring a degree of consistency given the broadly integrated financial services sector (both within the UK and increasingly Europe). Moreover, in certain areas it is recognised that there would have to be strict alignment to satisfy commonality in related prudential areas.

**Crisis Management, Resolution and Deposit Protection**

9.45 The new reforms on supervision and oversight aim to reduce the likelihood of future crises and allow for much earlier intervention to reduce the scale of any impact on the real economy.

9.46 However, it is still important to have in place structures to deal with any eventuality. In addition to supervision and regulatory issues therefore, the framework would enshrine an effective resolution mechanism and deposit protection scheme.

9.47 Financial crises require close coordination of monetary, fiscal and regulatory authorities.

9.48 At the centre of the framework is the proposition for issues of financial stability – including lender of last resort facilities for financial institutions – and crisis management to be coordinated on a pan-Sterling Zone basis. This would allow the Bank to continue to use the powers and authority under the UK Banking Act 2009 and would also reflect the integrated nature of the current UK financial services market.

9.49 While these activities, in all but the worst of financial crises, are likely to be conducted in the main at arms-length from government, if and when any input was required from a fiscal authority – for example an indemnity was sought to underwrite a particular intervention – this could be coordinated through the ‘Macroeconomic Governance Committee’.

9.50 For example, the proposition is that the Bank, as the institution responsible for financial stability, would provide liquidity support\(^\text{128}\) for institutions across the Sterling Zone as part of its day-to-day operations. This would be entirely consistent with common prudential regulation of systemically important institutions and overall macroprudential stability.

\(^{128}\) This liquidity support is sometimes referred to as “lender of last resort” facility
9.51 If such an intervention was beyond the Bank’s published framework, or if the sums involved were large or the outcome uncertain, the Bank may seek an indemnity.

9.52 Depending upon the nature of the intervention this could be discharged jointly in accordance with the shareholder framework as set out above.

9.53 Following the financial crisis, the Banking Act 2009 created a Special Resolution Regime (SRR), which established a framework for dealing with distressed deposit taking institutions. The new ‘Crisis Management’ framework for financial stability that the UK is moving towards will ensure that the Bank is responsible for identifying potential crises, developing contingency plans and implementing solutions. This includes decisions on transferring distressed operations to the public sector, private sector (e.g. takeover) or to the Bank.

9.54 This proposition effectively retains the Bank’s crisis management remit. Agreement will be required between the Scottish Government, the UK Government and the Bank to develop an effective authorisation and indemnity procedure for a system that has two separate fiscal authorities. This should be straightforward. A key aim will be to ensure that this enables swift and effective crisis management. It is proposed that this could be achieved through the effective operation of the ‘Macroeconomic Governance Committee’ outlined above.

9.55 Under such a scheme, the Bank of England would remain responsible for the operation of the SRR, including the decision on which of the tools to use, and their implementation.

9.56 As is currently the case, an exception would remain for the authority to take an institution into temporary public ownership (TPO). If in the future a failed institution required the use of the TPO tool – with implications for public funds – a mechanism would be in place, as part of the shareholder approach and Macroeconomic Governance Committee, to seek a fair contribution from both fiscal authorities.

9.57 This would ensure a fair, common and effective approach to ensuring stability across a shared financial and monetary area.
Finally, the framework establishes an appropriate arrangement for the protection of bank deposits and other financial products. Under EU rules, a common level of deposit protection set at €100,000 must be honoured across the European Economic Area (EEA).

The UK Financial Services Compensation Scheme (FSCS), which is currently funded by an industry levy administered by the FSA, offers compensation up to £85,000 per saver, per authorised institution.

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**Box 9.03: EU context**

The Scottish Government has made clear its intention for Scotland to be a member of the EU following independence.

Scotland is already an integral member of the EU – its vast assets in fishing, oil and gas, and renewables, its value as an export market to other member states, and its education system used by a significant number of European students, all make important contributions to the EU and Member States. For example -

- Scotland is the biggest producer of oil in the EU;
- more than 17,000 non-UK EU students were enrolled at Scottish HEIs in 2011/12;
- around 150,000 non-UK EU citizens live in Scotland.

Under paragraph 30 of the Edinburgh Agreement[^129] the UK Government and the Scottish Government have committed to work together constructively in the light of the outcome of the Referendum, whatever it is, in the best interests of the people of Scotland and of the rest of the United Kingdom.

Following a ‘yes’ vote in 2014, a process of negotiation would take place between the Scottish Government and the UK Government on the transfer of powers to an independent Scottish Parliament.

The Scottish Government has stated that it expects Scotland’s transition from membership of the EU as part of the UK to full independent membership will be negotiated from a position within the EU.

The Scottish Government is aware of existing European legislation and will ensure that its proposals, and any final agreed framework, are compatible with these requirements.

In the context of the macroeconomic framework, the obligations include those under the Treaty on European Union, the Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks and European Central Bank.

Under the current constitutional arrangement, Scotland sits within the UK in the context of its EU membership. The starting point in the design of this macroeconomic framework is therefore the existing obligations of the UK.

The design of the framework also starts from the position of well-developed and mature institutions in a highly developed economy. This provides important context for the overall objective of delivering stability and sustainability.

It is important to recognise that the macroeconomic framework will require negotiation and agreement with the rest of the UK and the EU.

There are a number of options which could be designed to meet EU requirements. Some of these requirements are evolving, as reforms are made at the EU level and the position of the UK is clarified. The framework is designed to be flexible to respond to these developments.

One area where this is especially important is in financial stability. EU Regulations and associated Directives identify a number of responsibilities for Member States. Countries must appoint one or more designated National Competent Authorities, to be responsible for financial regulation and supervision. It is for individual Member States to determine their own preferred architecture. This does not appear to preclude a framework, where two Member States could, for example, deliver a shared supervisory structure for aspects of financial regulation. Indeed, this would be consistent with trends towards a Banking Union at the EU level.

There are also existing EU Directives in related areas such as deposit protection. Emerging EU legislative proposals on deposit protection specifically state that the merger of schemes of different Member States shall not be precluded. As set out in the previous chapter, developments are also occurring at the EU level to ensure effective crisis management, including a proposal for an EU framework for bank recovery and resolution.
9 Macroeconomic Framework For Scotland

9.60 A similar scheme would be delivered in Scotland. Consistent with moves at the European level to harmonise DGS schemes, and reflecting the nature of existing pan-UK financial institutions, there is merit in looking to apply a consistent and commonly maintained scheme across the Sterling Zone. This would be something to be discussed and agreed with the UK Government. Again it is believed that such a scheme would, particularly given the complex nature of many bank business models and structures, be in the interests of both Scotland and the UK and it would also ensure a fair and efficient allocation of resources and responsibilities. It would also guard against free-riding.

Fiscal Policy

9.61 Within this proposed macroeconomic framework, fiscal policy would provide the key new levers for the Scottish Government to grow the economy and to tackle key challenges in Scottish society and Scotland’s economy.

9.62 In addition to aligning priorities to the unique circumstances of the Scottish economy and the preferences of the people of Scotland, opportunities would exist to put in place new tax and economic regulatory systems.

9.63 However, failure to operate within a framework of overarching fiscal responsibility runs the risk of undermining any attempt to use tax and spending policy levers in a positive way.

9.64 Over the past five years as a whole, it is estimated that Scotland has been in a stronger fiscal position than the UK. In 2010-11, the most recent year for which figures are available, Scotland had a net fiscal deficit of 7.4% of GDP, including a geographical share of North Sea revenue. The UK as a whole ran a deficit equivalent to 9.2% of GDP.

9.65 It is clear however, that as a result of both the relative weakness of the UK public finances prior to the financial crisis, and the scale of the negative impact of the downturn itself, Scotland and the UK will face a challenging fiscal envelope for at least the next 5 years irrespective of the constitutional framework.

9.66 This does however, present an opportunity to establish a framework that better promotes fiscal sustainability, learns the lessons of the past and puts in place strong foundations of responsibility to underpin future growth and prosperity.
9.67 The Scottish Government should seek to negotiate a fair and equitable share of outstanding UK public sector liabilities and assets.

9.68 After agreement was reached on the division of UK Government debt and assets, a transitional arrangement whereby outstanding debt was gradually transferred to both countries would seem to be a sensible and efficient solution. There are various technical ways in which this could be achieved.

9.69 In order to promote stability within the proposed monetary union, there is merit in putting in place a fiscal sustainability agreement, which covered overall objectives for ensuring net debt and government borrowing do not diverge significantly. To be credible, any agreement would require political commitment from both governments.

9.70 Given the relative importance of oil and gas revenues to the Scottish economy, and the prospects for fluctuations in revenues from this sector, the framework should look to incorporate a stabilisation fund to manage oil revenues. The Scottish Government could plan budgets on a cautious estimate for oil revenues and invest any upside variability in the form of higher tax revenues in a fund, which can be used to guard against future unexpected falls in revenue or asymmetric shocks. With careful management, such a fund could evolve into a more general wealth fund to promote inter-generational equity.

9.71 At an administrative level, the Scottish Government could establish a framework for day-to-day management of fiscal policy. This could include, in time, a Scottish Debt Management Office, an Exchequer function for government, an effective tax collection agency and budgetary management process (including cash flow management and government banking services).

9.72 In response to a recommendation from the Council of Economic Advisers, the Scottish Government has agreed to establish a Fiscal Commission which could provide expert advice on economic forecasts. In time, the Working Group considers that as part of the framework for an independent Scotland, it could have a wider advisory role than simply a body to oversee the transparency and robustness of economic forecasts by advising on economic and fiscal policies. This would help provide credibility to markets and potential investors.
Box 9.04: Institutions to deliver a successful macroeconomic and fiscal framework in an Independent Scotland

It is envisaged that the proposal for a macroeconomic framework outlined in this chapter will itself be underpinned by the establishment of a set of institutions. These will deliver key functions of the framework and meet requirements both to ensure the effective functioning of a formal monetary union and membership of wider international organisations.

**Macroeconomic Governance Committee**

An institutional arrangement, a ‘Macroeconomic Governance Committee’, would meet to oversee matters which require input from both the Scottish and UK Governments. This could include decisions over governance of the shared institutions, whilst ensuring effective policy coordination as and when required.

**Fiscal Commission**

The Council Of Economic Advisers has already recommended, in their December 2009 annual report, that a Fiscal Commission should be established. The Council set out that the responsibility of such a commission would be to review the fiscal outlook for Scotland.

The Scottish Government supported the creation of a Fiscal Commission alongside moves to greater autonomy.

As part of the proposition, it is envisaged that this independent body could over time have a wider role than just fiscal policy and provide advice and guidance to the Scottish Government on other aspects of macroeconomic policy. This would include issues such as economic forecasts and expert advice on economic policy options. Ultimately, fiscal decisions would rest with democratically elected policymakers.

**Scottish Monetary Institute**

An independent Scotland should build its capability in macroeconomic management. The role of a Scottish Monetary Institute would include leading on analysis of the Scottish economy, developing the necessary statistics to inform this, building strong links with the shared central bank, and reporting to relevant international institutions.
Other institutions

The work of the Fiscal Commission Working Group will continue to examine the potential role of institutions that would need to be put in place to meet the new responsibilities of an independent Scotland and to ensure successful implementation of its macroeconomic and fiscal framework.

Conclusion

9.73 The framework outlined above provides a broad overview of the emerging proposition for a macroeconomic framework for an independent Scotland.

9.74 It takes the status quo as a starting point, and is designed to be robust, flexible and attractive to key partners in the rest of the UK and the EU. Ultimately, the exact framework will be negotiated with these partners, and be subject to the views and preferences of the Scottish Government and Scottish Parliament of the day. Many of these discussions may not take place until after the referendum. However, the Working Group is confident that such a framework would secure that agreement.

9.75 From the perspective of the UK, it would retain an integrated market with a key trading partner – Scotland. As nearly 10% of the existing UK economy, Scotland would remain one of the largest trading partners of the UK economy. There would be particular advantages for the UK in areas such as energy and financial services.

9.76 Moreover, the framework proposed for monetary policy, financial stability and fiscal policy offer fully engineered solutions to some of the challenges facing monetary unions. For example, the proposals for financial stability would ensure that institutions based in Scotland and operating in the rest of the UK would be subject to similar levels of oversight and scrutiny (and vice versa). The Working Group believe that there is no persuasive reason to suggest that this would in some way work against the UK’s interest relative to other options if independence was secured.

9.77 It has been claimed that a model of monetary union poses Euro Area style risks to Scotland. This is a false argument for this proposed framework. It is better designed (by incorporating key elements of fiscal and financial stability policy) and structured for two
9 Macroeconomic Framework For Scotland

 economies which are structurally, cyclically and institutionally more aligned than members of the Euro Area.

9.78 The framework proposed would represent a substantial step-change in the economic responsibilities of the Scottish Parliament and greatly increase the levers at the disposal of policymakers in Scotland.

9.79 It is also designed to be flexible and able to evolve should the people of Scotland wish for reform in the future or economic conditions change post-independence. This is a key aspect of restoring economic sovereignty.
Chapter Summary

- Independence presents key choices in the design of the macroeconomic framework under independence, including currency arrangements, financial stability and fiscal policy.

- While there may be merit in pooling and coordinating some key aspects of macroeconomic policy, the decisions around what was in the best economic interests would rest with the Scottish Parliament. As with any movement to a new framework, there will be trade-offs to consider and debate fully. The Working Group believes that this first report provides an important contribution to the debate.

- Independence would establish the maximum degree of policy discretion and accountability over economic policy to improve long-term competitiveness and short-run responsiveness.

- It would give the Scottish Government the full range of economic levers to deliver increased sustainable economic growth and to tackle inequalities.

Introduction

10.1 This first report of the Working Group has identified a number of recommendations for the Scottish Government to consider. Alongside this, the report also sets out thinking about the design of a macroeconomic framework post-independence to help meet these recommendations.

10.2 Much of the report has concentrated on the practicalities of ‘how’ independence could work. The focus of future work of the commission will be on the opportunities that could exist for Scotland under independence and the policy-making lessons that can be applied to Scotland from the experience of other countries. There will also be work undertaken to consider transitional arrangements.

10.3 The Working Group acknowledges that the Scottish Government believes that independence would provide Scotland with the opportunity to capture and deliver faster
Conclusions and Future Work

sustainable economic growth with greater opportunities to tackle key challenges in sustainability and inequalities over the long-term.

Macroeconomic Framework Principles

10.4 As highlighted in Chapter 3, the Scottish Government has two clear overarching objectives to underpin the design of an overall economic framework for Scotland:

- **long-term competitiveness** – maximising opportunities to raise productivity, competitiveness and economic growth over the long term; and
- **short-run responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

10.5 Independence would mean that decisions and policies could be tailored to the specific needs and circumstances of the Scottish economy – both in the short-term and long-term – creating a clearly accountable link between the development of economic policies and the performance of the economy. With these new opportunities would also come new responsibilities.

Long-term competitiveness

10.6 A macroeconomic framework that enhances long-term competitiveness is vital in delivering an environment conducive to faster sustainable economic growth.

10.7 Independence would have important implications for:

- the degree of autonomy to tailor policies to distinct circumstances of the Scottish economy;
- the breadth of opportunities to extend competitive advantages; and,
- the efficiency of the delivery of public services and the degree of accountability and transparency.
Degree of autonomy to tailor policies to distinct circumstances of the Scottish economy

10.8 Under independence, Scotland would move from a situation where 16% of its own revenues were raised by the Scottish Parliament to 100%. At the same time, responsibility for key policies such as tax rates and allowances would be the responsibility of the Scottish Parliament, while all revenues raised in Scotland from taxation and non-taxation (e.g. revenues from the Crown Estate) would be retained.

10.9 The Working Group acknowledges that the Scottish Government believes that there are a number of reasons why the current system limits the opportunities for long-term competitiveness.

10.10 For example, it is often argued it is the case – for a variety of reasons – that policy is developed from a broad UK perspective without specific consideration of the Scottish context. As a result, it is not the case that UK policies are necessarily wrong but that they are designed with the impact at the UK level in mind. This can have practical implications in a number of areas.

10.11 In addition, independence could in theory also allow opportunities to develop nuances within the system to support local competitive advantages. Targeted policy response can be advantageous particularly in areas of economic activity which have a relatively higher priority in Scotland than in the rest of the UK.

10.12 For example, policies could be targeted at specific sectors where Scotland has a particular comparative advantage (i.e. in international trade) or at aspects of economic activity such as capital investment, investment in skills and research and development.

10.13 Of course, all such policy choices would have to consider the funding challenges and pressures in other areas. This responsibility is part and parcel of being independent.

10.14 It is not just on the taxation side where independence could provide new opportunities, but also through shaping the regulatory framework. It could also create more opportunities to design and implement coherent interventions using a range of policy levers which reflected the potential for synergies between various policies (i.e. tax and spending inter-linkages).
Conclusions and Future Work

The proposed Fiscal Commission could provide advice on the overall performance of the Scottish economy and offer guidance on the range of policy options open to government. One lesson of the recent crisis has been the importance of diversification to ensure economic resilience. Risks in the private sector which have the potential to become contingent liabilities of the public sector also need to be considered. While the structure of the Scottish economy is not dissimilar to the rest of the UK, opportunities to improve the breadth and competitiveness across a wider set of companies, industries and sectors would benefit Scotland. The framework proposed would provide more tools to achieve such structural change.

It is important to note however, that independence would take place within the wider context of globalisation and intra-national institutions such as the EU. This will have implications for competition policy and other economic policies (including economic regulation). In this regard, the focus of the future work of the commission will be making the clear distinction between ‘economic independence’ (i.e. operating in a unilateral environment) and the ‘economics of independence’ (i.e. the local autonomy to maximise growth and opportunities within a complex global economic environment).

As an open economy, Scotland’s relationship with the international economic and financial community will be particularly important. As an independent sovereign state with a new ability to shape and influence policy at the international level this would fundamentally change Scotland’s place in the world and the global economic community.

Breadth of opportunities to extend competitive advantages

More generally, independence would provide the Scottish Government with greater access to the tools to promote competitive advantages, both within the UK and also internationally.

There could be opportunities for example to support the overall business environment, by careful use of tax powers. In addition to competing for investment through the development of Scotland’s human capital and natural resources, efficient use of business taxation can be an important tool to encourage decision-making centres to settle in Scotland.
10.20 Again, such policies would need to be affordable and need to fully consider the wider implications of particular policy choices.

10.21 Recent assessments, such as the Mirrlees Review, have identified the characteristics of an effective tax system for modern developed economies. Independence would provide the opportunity to consider the design of a simplified tax system which was effective and efficient and tailored to the unique strengths and needs of the Scottish economy. This is something that will be the focus of a future piece of work by the Working Group.

Box 10.1: Policy Opportunities Post-independence

Under independence, the Scottish Government would have a range of new policy levers to boost growth, address inequality and stabilise the economy.

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<thead>
<tr>
<th>Fiscal and Taxation</th>
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<tr>
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<tr>
<td>• Oil and Gas Taxation</td>
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The Scotland Act 2012 will provide the Scottish Government with an increase in tax powers. However, the majority of Scotland’s tax revenues (84%) will continue to be set by the UK Government.

Under independence, the Scottish Government could assess whether the current tax system is appropriate for Scotland or whether a more radical overhaul is required.

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10.22 Independence would also provide an opportunity to review the wider business and economic regulatory framework to assess the opportunities that aligned and proportionate policies could bring in support of sustainable economic growth.

**Efficiency of the delivery of public services and the degree of accountability and transparency**

10.23 Finally, having full control of the economic policy levers means that the Scottish Government would be fully responsible, and accountable, for tackling the key challenges that Scotland will face in the years ahead. This includes issues such as re-balancing the public finances, taking action to address inequalities and putting in place the foundations to promote environmental sustainability over the long-term. Responsibilities and tough choices will increase just as significantly as policy opportunities and autonomy.

10.24 A key principle for efficient policy delivery is for decision-makers to balance the marginal benefits of particular spending decisions with their respective marginal costs, and vice versa. The creation of an effective budget constraint is essential in ensuring efficient delivery of public services.

10.25 Under independence, policy choices would have clear and identifiable implications for revenues (and/or borrowing requirements) and would encourage maximum rigour in the budget and economic policy making process.

**Short-run responsiveness**

10.26 Changing preferences, technological breakthroughs, financial instability, natural disasters or political developments can all change the economy, often unexpectedly and over short time periods.

10.27 Therefore alongside ensuring that conditions are conducive for long-term competitiveness, the ability to respond flexibly to changing economic circumstances is an important element of macroeconomic policy.

10.28 This is especially important during periods of economic uncertainty. The ability to respond swiftly and decisively to short-term economic pressures and challenges is vital to minimise negative shocks to growth, jobs and investment, and to enable a stronger, faster recovery.
There are three aspects to this

- Macroeconomic stability
- Budgetary Stability & Affordability
- Flexibility

**Macroeconomic stability**

As highlighted above, an advantage of greater economic autonomy is that policies can be set to address the unique challenges of a particular locality. A 'one-size-fits-all' economic policy strategy by definition is unable to do this. However, against this, being part of a wider economic union can help ‘risk-pooling’ and allow for ‘collective action’ in times of stress.

Under the current constitutional framework, responsibility for macroeconomic stability rests almost entirely with the UK Government. The Scottish Government has some policy levers – for example, the opportunity to re-profile its spend – but such opportunities are minor within the wider context of overall macroeconomic stabilisation.

With independence the Scottish Parliament would have greater flexibility to put in place the optimal choice of macroeconomic policies to ensure stability, including borrowing. Responsibility for management of any net borrowing and national debt would lie with the Scottish Government.

The trade-off in terms of risk-pooling and collective action, depends upon the degree of commonality in business cycles and exposure to asymmetric shocks. This is discussed in Chapter 7 and the accompanying paper on ‘currency options’. Such issues could be handled through appropriate design of institutions – see for example the proposals for financial stability and the creation of a stabilisation fund – though will need to be monitored and carefully managed on a continual basis.

**Budgetary Stability & Affordability**

At present, through the Barnett Formula and the setting of multi-year UK spending plans, the current framework provides predictability for the devolved Scottish Budget.
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10.35 Under independence, these spending plans – and all other elements of public spending – along with the management of budgetary responsibility would transfer to the Scottish Government and Scottish Parliament.

10.36 The relative fiscal strength of a country raises important considerations as to the best design of policy making and fiscal framework. On the one hand, a centralised system can allow for transfers from more prosperous parts of a fiscal union to relatively poorer ones.

10.37 However, a reliance upon such ‘transfers’ can lock less well-off areas into lower levels of growth. Long-term economic development is unlikely to be achieved on a sustainable basis by transfers and redistribution alone.

10.38 There has been considerable debate about Scotland's fiscal position.

10.39 As highlighted previously, including a geographical share of North Sea oil, Scotland is estimated to have been in a relatively stronger fiscal position than the UK as a whole in recent years.

10.40 A country’s fiscal position and sustainability is directly correlated with its borrowing costs. A weak fiscal position and/or outlook would lead to higher borrowing costs. This would reduce long-term competitiveness.

10.41 As this analysis takes the current constitutional and fiscal framework as given, however, care should be taken in using these figures when attempting to forecast Scotland's fiscal position under alternative fiscal frameworks. The value would depend largely on the policy choices of the government of the day, the economic climate and any settlement of UK assets and liabilities.

10.42 A key challenge for Scotland – irrespective of the constitutional settlement – will be ensuring long-term fiscal sustainability. Areas which the government should focus would have to include establishing credibility in debt markets in the short-term and engaging in long-term planning to boost the scope of onshore tax revenues and to reduce pressures on expenditure in key areas.

10.43 As highlighted above, a number of resource rich countries and regions within countries have established oil funds to assist in stabilising their economies, or to underpin long-term
social provision. A stabilisation fund for Scotland could, in principle, be used in a similar manner. The Working Group believes that this would significantly enhance the economic protection currently available to the people of Scotland.

10.44 New institutions will be required to be established in an independent Scotland. Lessons can be taken from the successful operation of other small independent countries. In this regard it is important to note that ‘smaller’ countries are not necessarily scaled down versions of ‘larger’ economies. There is often greater scope for exploiting efficiencies and pooling activities. Against this there are issues around economies of scale.

10.45 The Scottish Government will be required to commit to set out a clear and detailed budgetary and administration package to govern the transition to independence. Ultimately, the fiscal and economic success of Scotland under independence would depend upon the policy choices of the government and economic performance over the long-term. Managing transition is an area that will be explored in future reports.

**Flexibility**

10.46 There are two forms of flexibility that would be important to Scotland under independence.

10.47 Firstly, an independent Scotland would need to tailor responses to its specific circumstances using levers such as borrowing for capital spending and investment. It would also be required to use these levers to tackle problems and areas which were underperforming relative to the rest of the economy. These choices offer trade-offs – and often are not easy – but will be vital to ensuring long-term prosperity.

10.48 Secondly, independence would in theory provide the opportunity to develop a system that responds to developing circumstances in Scotland and create policies which are in its best interests at that time.

10.49 Successful macroeconomic frameworks are designed around the key principles that the Working Group have set out in this report (credibility, sustainability, stability and autonomy). These principles could, with clear lines of democratic accountability, help ensure that the framework can operate not just from day 1 and through transition, but also provide the long-term stability required to deliver sustainable economic growth.
Conclusions

10.50 Scotland has the clear potential to be a successful independent nation. Part of the series of steps toward independence would include the creation of a robust macroeconomic framework.

10.51 This report has outlined the emerging thinking of the Fiscal Commission Working Group around a workable macroeconomic model for day 1 of independence. It combines a balance of continuity and flexibility that will be the key to unlocking Scotland’s economic potential.

10.52 This is the first in a series of publications from the Working Group to help shape and inform the economic debate in advance of the referendum. Future work will focus on many of the key issues identified in this report and the opportunities that could emerge for Scotland under independence.
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Asymmetric Shock – A macroeconomic shock that is unique to a particular locality – e.g. a country or region.

Bail-in – A method of Resolution that features in new international proposals for future intervention to address financial crises. A key feature of the approach is that it would impose losses on the shareholders and unsecured creditors of a failing bank before taxpayer funds were put at risk.

Bail-out – A method of Resolution whereby the government injects capital into a potentially insolvent institution to maintain its operations. This may also involve the government taking temporary ownership of all or part of the bank’s operations.

Balance of Payments – A measure of the difference between a country’s exports and imports, including financial transactions. It is a measure of all economic transactions made between a country and all other countries during a specified timeframe.

Banking Union – Emerging EU proposals which include common cross-border approaches to supervision and oversight, resolution mechanisms and deposit insurance.

Barnett Formula – The formula that determines changes in the funding allocation for the overall Scottish Government Budget. It determines the change in the Block Grant based on the quantity of the planned change in UK Government spending, the extent to which the Whitehall departmental program is comparable to the services carried out in Scotland and Scotland’s population as a proportion of England, England and Wales, or Great Britain, as appropriate.

Block Grant – A monetary transfer from the UK government to the Scottish Government to fund the devolved government’s spending. The change in the block grant each year is determined by the Barnett Formula.

Business Cycle – The recurring fluctuation in overall economic activity that economies exhibit over time.

Capital Adequacy Rules – Rules surrounding the quality and quantity of capital that banks must hold at all times to enable them to maintain adequate Liquidity in the event of a downturn.

Central Bank – The institution that is responsible for the implementation of Monetary Policy. Usually, a central bank will have additional powers. These might include oversight of the payment and settlement systems, the issue of banknotes, carrying out research and providing advice. Increasingly, some central banks are being given wider mandates to pursue Financial Stability alongside Price Stability and are being given increased powers to facilitate this.

Collateral – An asset that is used to guarantee a loan. In the event that the debtor is unable to repay the loan amount, the collateral may have to be forfeit in order to refund the creditor.
Glossary

**Consumer Price Index (CPI)** – A measure of inflation calculated by observing price change in a representative basket of goods over time.

**Contingent Liability** – A liability that will only be realised if a certain event occurs.

**Credit Rating** – A subjective measure of a country’s or company’s relative credit risk.

**Credit Risk** – A measure of the perceived likelihood that a borrower will be unable to repay a debt. This affects the **Interest Rate** the borrower will have to pay.

**Currency Area** – A group of countries engaged in **Monetary Union**.

**Currency Board** – A board created with the objective of supporting a permanent **Currency Peg** through **Monetary Operations**.

**Currency Peg** – A fixed exchange rate regime, whereby the **Monetary Authority** carries out **Monetary Operations** with the intent of maintaining a pre-determined **Exchange Rate** with another currency. This was attempted by a number of European countries, with varying levels of success, prior to the establishment of the Euro Area.

**Debt Management** – The way in which a government manages its borrowing and stock of debt to minimise costs and risks.

**Deposit Protection** – A scheme of collective insurance for certain types of deposit in financial firms in order to increase confidence in the **Financial System** and prevent bank runs. Can be funded ex-ante or ex-post and is usually paid for by the financial services industry.

**Economic Shock** – A large, unexpected change in an economic variable such as **Inflation**, output or **Unemployment**.

**Economic Union** – An agreement between two or more countries to commit not only to **Monetary Union** but also to coordinate/share other economic policies.

**Exchange Rate** – The rate at which one currency can be converted into another.

**Factor Mobility** – The ease at which factors of production, such as labour and capital, can move freely across borders in response to changes in demand.

**Financial Regulation** – Regulations that prescribe the proper functioning of the **Financial Sector**.

**Financial Sector** – The collection of firms providing financial services in the economy.

**Financial Stability** – A measure of the stability of the **Financial System**. This should include the soundness of individual firms, the ability of firms to carry out business with one another and the build-up of potential risks to the sector’s future performance (including implications for the real economy).
Glossary

**Financial Stability Framework** – The set of institutions and policies that seek to preserve Financial Stability.

**Financial System** – The system comprised of financial firms and the business that they carry out, between themselves and between themselves and customers. This would include payments systems and credit markets.

**Fiscal Authority** – A governmental institution, such as a treasury, with the power to raise taxes, engage in government spending and control the public sector balance sheet.

**Fiscal Commission/Council** – An independent body established to support the development of robust fiscal policies and to promote sustainability. The responsibilities may also include independent forecasting, analysis of government economic policy and oversight of Fiscal Rules.

**Fiscal Framework** – The set of policies that define the fiscal powers of the government. Governments may choose to constrain themselves through the implementation of Fiscal Rules.

**Fiscal Policy** – Policies which aim to influence economic growth and inequalities through government spending and tax policies.

**Fiscal Rules** – A stated set of rules that concern budgetary balances, or debt limits. These could be overseen by a Fiscal Commission.

**Fiscal Sustainability** – The pursuit of spending and borrowing policies that are sensible, and do not damage the economy’s long-term prospects.

**Gini Coefficient** – A measure of income inequality between 0 and 1, with inequality increasing as the coefficient tends to 1.

**Globally Significant Financial Institution** – An institution with cross-border operations of such magnitude that their failure would negatively affect not only the financial system in their home country, but the global Financial System, reducing the world-wide level of Financial Stability.

**Gross Domestic Product (GDP)** – A measure of the value of goods and services produced in a country. It is equal to Gross Value Added at basic prices plus taxes (less subsidies) on products. Alternatively, it is equal to the sum of total final domestic consumption expenditures less imports of goods and services.

**Gross National Income (GNI)** – A measure of the total value of goods and services produced within a country together with its net income received from other countries.

**Gross Value Added (GVA)** – The contribution to the economy of each individual producer, industry or sector. It is a measure of GDP in basic prices.

**Indemnity** – A guarantee to repay a loan to a third party should the third party be unable to do so in the future.
Glossary

**Inflation** – The rate at which the price of goods and services is rising or, conversely, purchasing power is falling.

**Inflation Targeting** – The policy adopted by most central banks, which aims to achieve a pre-defined rate of Inflation each year.

**Interest Rate** – The rate at which banks and individuals can borrow money. Traditionally, this is the key variable through which Monetary Policy is transmitted.

**Labour Force Participation** – The percentage of the adult population in the labour force.

**Lender of Last Resort** - The safety net that a central bank extends to a solvent financial institution when it cannot obtain liquidity from market sources. It can also refer to the role that a central bank has in the provision of market-wide liquidity.

**Liquidity** – A measure of how able a financial institution is to convert its assets into a more suitable medium of exchange (i.e. monetary balances). Cash and central bank reserves are the most liquid of assets. At times of high Volatility, it may not be possible to find a buyer for some types of risky or sparsely traded assets. Such assets are considered illiquid and may not be considered suitable under Capital Adequacy Rules.

**Liquidity Shocks** – Unexpected reductions in the amount of Liquidity in the Financial System. This can often be characterised by a freezing in inter-bank money markets.

**Macroeconomic Framework** – The set of institutions and policies that comprise the oversight and operation of the macroeconomy. The framework depends on the Monetary Framework, the Financial Stability Framework and the Fiscal Framework.

**Macroeconomic Modelling** – A technical economic model which uses data and statistical analysis to describe the economy quantitatively, considering macroeconomic variables such as inflation and unemployment.

**Macroeconomic Policy** – The Government’s policies which aim to influence the macroeconomy. This primarily relates to Monetary Policy and Fiscal Policy but may also include elements of Financial Regulation.

**Macroeconomic Stability** – A situation where key macroeconomic variables are stable and free from any unexpected shocks or are able to respond quickly and effectively to such shocks.

**Macroeconomy** – A description of an economy taken as a whole. It is also defined as the aggregate outcome of the actions taken by individuals in the economy. Key macroeconomic variables include Unemployment, Inflation and Interest Rates.

**Macroprudential Regulation** – Regulations that seek to prevent the build-up of imbalances such as asset bubbles that pose a systemic threat to the Financial System.

**Microprudential Regulation** – Regulations that ensure the soundness of individual firms within the economy.
**Monetary Authority** – The institution responsible for the implementation of **Monetary Policy**. In most countries this is the **Central Bank**.

**Monetary Framework** – The set of government policies that define the responsibilities and powers of the **Monetary Authority**, and, additionally, fundamentals such as the choice of currency.

**Monetary Operations** – Mechanisms through which a **Central Bank** can influence the **Interest Rate** and in doing so implement **Monetary Policy**.

**Monetary Policy** – A set of policies (interest rates, money supply etc) that – typically a Central Bank – uses to maintain price stability and to smooth economic fluctuations. In most countries, day-to-day monetary policy is devolved to an independent central bank.

**Monetary Stability** – See **Price Stability**

**Monetary Union** – The situation where two or more countries use the same currency (for example the Eurozone). This would be complimented by shared institutions concerned with the oversight of monetary policy.

**Moral Hazard** – The risk of inefficient outcomes which can occur in situations in which an individual or organisation does not bear the full consequences of their actions.

**Net Fiscal Balance** – The difference between estimated total public sector spending for Scotland and estimated total public sector revenue raised in Scotland.

**Nominal Variables** – Variables that are not measured in constant price terms and so will be affected by **Inflation**.

**Output per head** – A measure of the relative wealth of a country. Usually measured by GDP per head or GVA per head.

**Policy Levers** – The ability to implement policies in a certain policy area. An example of one such area would be competition policy.

**Price Stability** – The situation where prices are stable, or are rising at a rate expected by the actors within the economy. This is a stated objective of most **Central Banks**.

**Productivity** – A measure of how efficient an economy is able to convert its inputs in the production process (e.g. labour and capital) into outputs. It is the key long-term driver of economic growth in advanced economies. It is typically measured by output per hour worked or output per job.

**Prudential Regulation** – Regulations that seek to maintain financial stability. Can seek to influence the wider **Financial System** (**Macroprudential Regulation**) or individual firms (**Microprudential Regulation**).

**Quantitative Easing** – A mechanism whereby a **Central Bank** buys financial assets (typically government bonds) in exchange for newly created central bank reserves. This increases the level of **Liquidity** within the **Financial System** and, theoretically, promotes lending and economic activity.
Glossary

**Real Variables** – Variables measured in constant price terms, eliminating the effect of inflation.

**Regulatory Authorities** – The institutions within an economy that are charged with the implementation of financial regulation.

**Resolution** – The process through which a failed bank is placed in administration. The relevant governments or fiscal authorities may wish to intervene in the process if the disorderly resolution would adversely affect financial stability.

**Resolution Mechanism** – The mechanism through which an insolvent bank is wound down. This may include temporary public ownership. Possible approaches would include a Bail-In and a Bail-Out.

**Scottish Consolidated Fund** – The main account of the Scottish Government, into which the block grant is paid.

**Seigniorage** – The revenue raised by the central bank through the issue of currency. This is sometimes referred to as the “inflation tax”.

**Stabilisation/Stability Fund** – A fund held by a government to smooth the effects of fluctuations in revenues and expenditures caused by economic conditions. Such a fund would be raised during periods of economic strength in order to support government spending during recessions, when spending on welfare generally increases and tax receipts fall.

**Sterling Zone** – Proposal for a monetary union with the UK following Scottish independence.

**Systemic Risk** – Risks which can have consequences across a number of institutions and which have potential detrimental impact on financial stability.

**Unemployment** – The proportion of the population actively seeking work but unable to find a suitable job.

**Volatility** – A measure of a variable’s tendency to change over time. Variables that are highly volatile change frequently and to a large extent. In the context of the macroeconomy, such conditions create uncertainty, which can damage confidence in the financial system and adversely affect financial stability.