Division of UK Public Sector Debt – Implications for Scotland and the Rest of the UK

The Scottish Government set out in *Scotland's Future* a proposal to negotiate a fair share of assets and liabilities following a vote for independence. These assets include a range of institutions and tangible and intangible assets. This includes the Bank of England nationalised in 1946. The Bank holds almost a third of UK public sector debt.

"Following a vote for independence, the Scottish Government will negotiate with Westminster to agree a sharing of assets and liabilities that is fair, equitable and reflects Scottish needs and those of the rest of the UK." Scotland's Future, Page 345.[i]

On 13 February 2014 HM Treasury asserted that on independence the rest of the UK would be a "continuing state" and that national institutions currently serving the people of the UK would continue to carry out functions in the rest of the UK only. The Scottish Government believes that the future role of such institutions in the rest of the UK and Scotland should be a matter of negotiation consistent with the constructive approach set out in the Edinburgh Agreement.

Whilst Professor James Crawford and Alan Boyle provided their view to the UK Government on the issue of continuator state, they made clear that the status of Scotland and the rest of the UK on independence will depend on agreement,
"In practice, its [Scotland's] status in international law and that of the remainder of the UK (rUK) would depend on what arrangements the two governments made between themselves before and after the referendum, and on whether other states accepted their positions on such matters as continuity and succession".

The implications of arguing that the UK is the continuing state has been noted by experts:

<u>Professor Christine Bell (University of Edinburgh, Constitutional Law) argued in February 2014 that the UK Government retains liability for UK public sector debt[ii]:</u>

"Legally under international law the position is clear: if the remainder UK keeps the name and status of the UK under international law, it keeps its liabilities for the debt. The UK took out the debt, and legally it owes the money. Scotland cannot therefore 'default'."

<u>Prof. David Scheffer: Director of the Center for International Human Rights, Northwestern University School of Law (3rd March 2013)</u>

"Finally, the Whitehall report's bold presumption that national liabilities would have to be negotiated and thus shared between Scotland and the rUK under the continuator theory rests on very thin ice. On what legal basis would Scotland be obligated to assume any significant level of United Kingdom liabilities if the rUK is the continuator State?"

The Treasury itself accepted the logic of its position when it gave notice on 13 January 2014 to markets that they would honour the contractual terms of debt issued in the past by the UK:

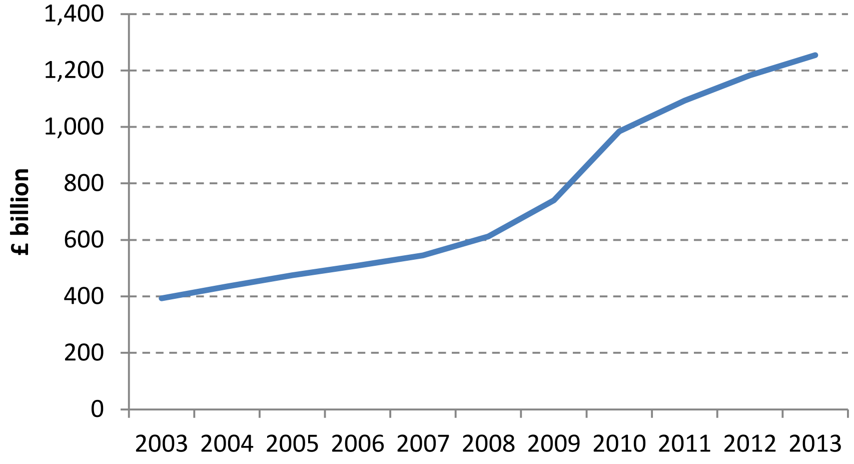
- *"In the event of Scottish independence from the United Kingdom (UK), the continuing UK Government would in all circumstances honour the contractual terms of the debt issued by the UK Government." (UK Debt and the Scottish independence referendum, 2013, p1)*[iii]

The following analysis sets out the consequences of the rest of the UK adopting the position of continuing state and assuming responsibility for servicing all outstanding public sector net debt. It is important to note that this would be the outcome of following the UK Government's approach in negotiations. Scotland would not be defaulting on debt.

Scotland's Future – Scotland's share of UK public sector debt

The UK public sector net debt (excluding the temporary effects of financial interventions) has increased significantly over the last decade from just under £400 billion in December 2003 to approximately £1.25 trillion in December 2013[iv].

Figure 1: UK Public Sector Finances – Net debt (£billion)

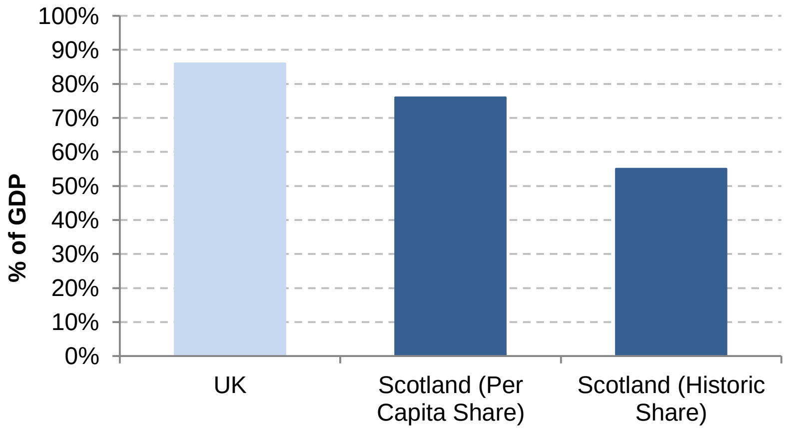


Scotland's Future reports that UK public sector net debt at the end of 2016-17 is forecast to stand at £1.6 trillion (86% of UK GDP)[v]. This is equivalent to over £24,000 for every person in the UK.

Scotland's Future outlined that following independence, the Scottish Government would inherit a share of the UK national debt as part of a fair division of public sector assets and liabilities. On this basis, the White Paper outlined two scenarios for Scotland's share of UK public sector debt and annual interest payments – population share and historic share.

- Scotland's population share of UK net debt would be equivalent to approximately £130 billion (76% of Scottish GDP) in 2016-17.
- Since 1980 Scotland's public finances, including oil, are estimated to have been in a stronger position than the UK. When estimated on the basis of its historic fiscal position, Scotland's share of UK public sector debt would be approximately £100 billion in 2016-17 (55% of Scottish GDP).

Figure 2: Scotland's Future - Share of UK Public Sector Net Debt, 2016/17



Scotland's Future - Forecasts for Scotland's fiscal position in 2016-17

Scotland's Future contained forecasts of Scotland's fiscal position in 2016-17, including either a per capita or historic share of UK public sector debt interest payments and under two different scenarios for North Sea revenue[vi].

In 2016-17, Scotland's share of public sector debt interest payments are forecast to be approximately £4 billion based on a historical share and £5.5 billion based on a population share.

With a historical share of debt interest, Scotland is estimated to run a fiscal deficit of between 1.6% and 2.4% of GDP in 2016-17. With a population share of UK debt, Scotland's deficit is forecast to be between 2.5% and 3.2% of GDP. (See table 1 below).

UK Government Statement on Outstanding UK Public Sector Debt

The UK Government announced in January 2014 that *"In the event of Scottish independence from the United Kingdom (UK), the continuing UK Government would in all circumstances honour the contractual terms of the debt issued by the UK Government."*[vii]

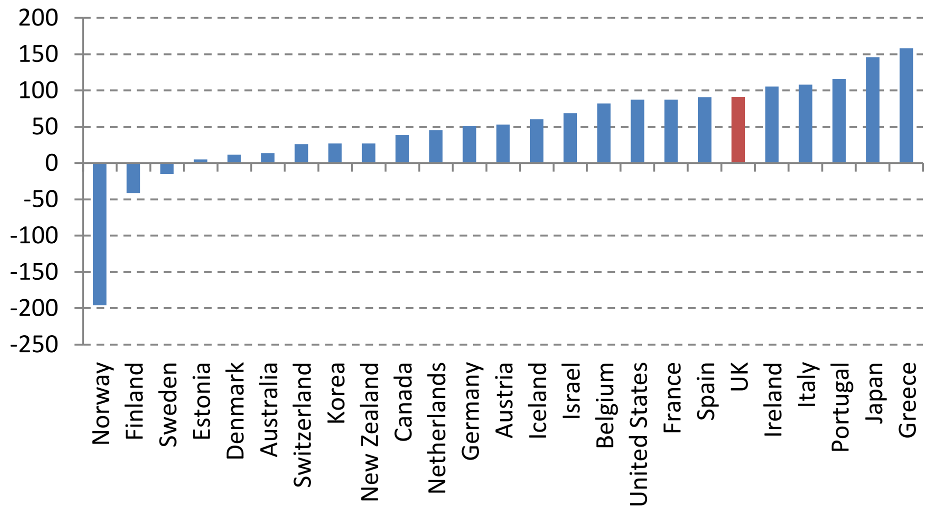
Impact on the rest of the UK of taking on all outstanding UK debts

Assuming that the rest of the UK retains responsibility for the entire outstanding stock of UK debt, which Scotland's Future forecast to stand at £1.6 trillion by 2016-17, this would imply a net debt to GDP ratio for the rest of the UK in excess of 95%.

The additional debt taken on by rest of the UK could be up-to £130 billion higher if the rest of the UK retained responsibility for all the UK public sector debt, than if Scotland assumed responsibility for a share.

This would increase the UK's debt burden relative to other countries, which on an internationally comparable basis is already high – see Figure 3.

Figure 3: General Government Net Debt, 2016 (%GDP)[viii]



Under this illustration, this would also result in an additional £4 billion to £5.5 billion a year in debt service costs for the rest of the UK. This is broadly equivalent to increasing the basic rate of income tax by 1p in 2016-17.[ix]

Impact on Scotland assuming the rest of the UK take on all outstanding debts.

Assuming the UK was responsible for outstanding debt and Scotland therefore was not required to make a contribution to debt interest payments, under such an illustrative scenario Scotland is forecast to be broadly in fiscal balance under the low North Sea revenue scenario and forecast to run a fiscal surplus of £1.1 billion under the higher North Sea revenue scenario.

Table 1: Net Fiscal Balance 2016-17(£billion)[x]

	North Sea Scenario 1	**North Sea Scenario 2**
Net Fiscal Balance (including historical share of debt interest)	-£2.7	-£4.0
Net Fiscal Balance (including population share of debt interest)	-£4.3	-£5.5
Net Fiscal Balance (£billion) – excluding debt interest	+£1.1	-£0.0

On the basis of these forecasts, in principle there would be only limited requirement to approach the markets and issue Scottish Government debt for cash flow purposes. Consequently future interest payments would be substantially lower.

Scottish Debt Interest Costs – Hypothetical Example

If an independent Scotland took on zero debt (see discussion above regarding UK's position as continuing State), both the need to raise funds from financial markets, and future debt servicing costs would be substantially reduced. This would not be a default as such debt belongs to the UK Government, who have already committed to honour it, and would reflect the outcome of the negotiated settlement between the Scottish and UK Governments.

As an illustrative example, the implied debt servicing costs on £1 billion of new borrowing by an independent Scotland at the current UK bond yield (2.8%) would be £28 million a year.[xi] Debt interest payments will therefore be a tiny fraction of the £4 - £5.5 billion cost of servicing a proportion of the UK's stock of national debt.

Future borrowing costs will depend upon the fiscal and economic strengths of the Scottish economy. A number of countries of comparable size to Scotland – including Denmark (1.9%), Finland (2.0%), Austria (2.2%) and Sweden (2.4%) – pay lower rates of interest than the UK on such borrowing.[xii]

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[i] http://www.scotreferendum.com/reports/scotlands-future-your-guide-to-an-independent-scotland/
[ii] Scottish Constitutional Futures Forum Blog (13 February 2014), http://www.futureukandscotland.ac.uk/blog/currency-reflections-legal-issues
[iii] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279454/CM8815_2901849_SA_SterlingUnion_acc.pdf
[iv] ONS Public Sector Finances, Net debt excluding the temporary effects of financial interventions. Table PSF8, http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/december-2013/rft---public-sector-finances-tables-1---12.xls
[v] Scotland's Future (Dec 2013) – Page 348. All the figures for UK public sector debt quoted in this note are consistent with those use in the White Paper. Since the White Paper's publication, the OBR has revised down their forecast of UK debt in 2016-17 to £1.5 trillion (79.9% of GDP). However, this has no impact on the conclusions drawn in this note.
[vi] The Scottish Government has published forecasts for North Sea tax receipts under a range of scenarios. Two scenarios are used here. In the first, production is assumed to remain unchanged at current levels, whilst oil prices are assumed to remain unchanged in cash terms at their average level over the two years to March 2013. Under such a scenario, Scottish oil and gas receipts are forecast to generate £6.8 billion in tax revenue in 2016-17. In the second scenario, production is forecast to increase more in line with industry forecasts, although at a lower level of profitability. Under this scenario, oil and gas receipts could reach £7.9 billion in 2016-17.
[vii] HM Treasury (13 January 2014) - UK debt and the Scotland independence referendum – Page 1
[viii] Source: Based on IMF World Economic Outlook data. https://www.imf.org/external/data.htm. There are 35 countries within the IMF advanced economies category, of these 25 countries report General Government Net Debt.
[ix] http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf
[x] Note – figures may not sum due to rounding.
[xi] Thomson Reuters Datastream, yields shown are for benchmark 10 year government bonds as at 12 February 2014
[xii] Ibid. (endnote vii)