



The
**Sustainable
Growth
Commission**

Scotland – the new case for optimism

A strategy for inter-generational economic
renaissance

The report of the Sustainable Growth Commission

May 2018

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

William Hutchison Murray 1913-1996

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

Mohandas Karamchand Gandhi 1869-1948

1 ABOUT THE SUSTAINABLE GROWTH COMMISSION

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

Remit

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

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

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

Commission Members

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

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

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

- Iain Docherty, Professor of Public Policy and Governance, University of Glasgow
 - Kate Forbes, MSP for Skye, Lochaber and Badenoch
 - Andrew Hughes Hallett, Professor of Economics and Public Policy, George Mason University and University of St Andrews
 - Dan McDonald, businessman and founder of N56 group
 - Derek MacKay MSP, Scottish Government Cabinet Secretary for Finance
 - Marie Macklin CBE, Founder and Chief Executive of the Klin Group and Macklin Enterprise Partnership
 - Jim Mather, former Enterprise Minister and Visiting Professor at the University of Strathclyde and Heriot Watt University
 - Roger Mullin, Honorary Professor at University of Stirling Management School, former MP and SNP Westminster Finance spokesperson
 - Catherine Schenk, Professor of Economic and Social History, University of Oxford
 - Mark Shaw, Chief Executive, Hazeldene Group
 - Shirley-Anne Somerville, Minister for Further Education, Higher Education and Science
 - Petra Wetzel, founder and Managing Director WEST Brewery
 - Andrew Wilson (Chair), Founding Partner, Charlotte St Partners
- 1.6 Research and logistical support has been provided by Graeme Blackett, Director of BiGGAR Economics. The coordination and organisation of the consultation and engagement programme was undertaken by Ian McAllan.
- 1.7 We are extremely grateful to Graeme Blackett and his team at BiGGAR Economics for their work supporting the Commission. We are also very grateful to David Skilling of Landfall Strategy Group, John McLaren (Scottish Trends) and Richard Marsh of 4-consulting and Professor Patrick Dunleavy of the London School of Economics for their work supporting some of the insights in the reports.
- 1.8 A number of other individuals offered personal insight, analysis and criticism throughout the process and they are too numerous to mention. All and every point made has been considered very carefully. We are especially grateful to our three senior Peer Reviewers who devoted very valuable time to offer very material improving comments and generally very supportive perspectives on the direction taken.

- 1.9 The data and evidence are sourced throughout the three sections of the report. All data is subject to update and revision but the data referenced was the most recent and comprehensive at the time of writing. During the course of the Commission's work, it has been necessary to update the analysis as new data has been published and it has been notable that the updates did not change the conclusions and recommendations reached. The analysis is based on an examination of the long-term performance and prospects of the Scottish economy and while monthly, quarterly or annual data releases do provide some insights, the focus of debate and energy should be on improving the long-term trajectory.
- 1.10 Finally, we are, of course, very grateful to the First Minister whose initiative this Commission is and who has offered all of us an historic opportunity to make a public service contribution to Scotland's policy debate. While we have briefed the First Minister and her colleagues as the research and analysis work has been undertaken, the content of this report is entirely the responsibility of the Commission and its members.
- 1.11 The content of this report is entirely the position of the Commission itself and should not be seen as necessarily reflecting the rounded views of any individual that has contributed commissioned work.

Engagement Process

- 1.12 At the first meeting of the Sustainable Growth Commission, one of the first suggestions made was that it was necessary to engage with a wide range of interests to gather views on what was required to improve performance. It was swiftly agreed that the Commission needed to consult as widely as time and resources would allow, so that the recommendations reflected not just the views of the Commission members, but a wide range of ideas from the sectors that make up the Scottish economy.
- 1.13 Many of the suggestions made during the engagement exercise have been discussed in the Commission's report and ideas that emerged became the subject of more detailed research.
- 1.14 Of the 23 organisations contacted, only Scottish Financial Enterprise declined a meeting so for this sector direct company engagement was undertaken. Oil & Gas UK, due to other unanticipated commitments on the day of the meeting, provided a written submission. The meetings and dates were as follows:
- Scottish Tourism Alliance (22.11.16)
 - Scottish Engineering (23.11.16)
 - Scotland-IS (24.11.16)
 - Scottish Life Sciences (28.11.16)

- Scottish Renewables (29.11.16)
 - Scottish Council for Development & Industry (2.12.16)
 - CBI Scotland (5.12.16)
 - Universities Scotland (6.12.16)
 - Institute of Directors (7.12.16)
 - Federation of Small Business (13.12.16)
 - Entrepreneurial Scotland (14.12.16)
 - Business for Scotland (20.12.16)
 - Social Enterprise Scotland (21.2.17)
 - Chemical Sciences Scotland (2.3.17)
 - Scottish Chamber of Commerce (7.3.17)
 - Technology Scotland (9.3.17)
 - Scottish Council for Voluntary Organisations (21.3.17)
 - Scottish Food & Drink (17.3.17)
 - Scottish Property Federation (21.3.17)
 - Law Society of Scotland (11.4.17)
 - Royal Society of Edinburgh, Business Innovation Forum (15.1.18).
- 1.15 The meetings were facilitated by at least two Commission members, (or the chair individually), with the numbers of organisation members in attendance ranging from three to twenty. The meetings were conducted under Chatham House rules.
- 1.16 The meetings were welcomed by those who took part, as an opportunity to consider what the future aspirations for the Scottish economy should be, where the opportunities are, what the constraints might be and what needs to change to improve performance.
- 1.17 It is anticipated that the report will provide the basis for further engagement and debate with all of those interested in shaping the best possible policy framework for Scotland, irrespective of their positions on whether or not Scotland should be an independent country. Indeed, we hope that much of the work we have produced could be of value to the debate on governing Scotland in advance of any future independence choice.

2 INTRODUCTION BY ANDREW WILSON, CHAIR

- 2.1 It has been a privilege for me to chair the Sustainable Growth Commission and I thank the First Minister, sincerely, for the opportunity.
- 2.2 The process of producing this report has made me believe more than ever, that independence is the best option for Scotland's future. By this I mean a country which has as much responsibility as possible for its own government while choosing to pool, share and co-operate with its partners across the rest of the UK and Ireland, Europe and internationally.
- 2.3 This is not based on any unwavering certainty or 'fundamentalism' on my part. Very few things in life are certain. As Richard Holloway has argued, "the opposite of faith is not doubt, it is certainty"¹. I constantly challenge and am challenged in what I believe to be true. However having revisited every assumption, belief and opinion I have held to date in the production of this work, my faith in Scotland's future potential as a normal independent country is resilient. I have always felt that Scotland's 'journey begun long ago, and which has no end'² could only ever progress at the pace of a rational and questioning people. I recognise the challenges to many of each step on this journey not least because of a strong sense of British identity, which I, for one, share. We must seek to maintain a respectful dialogue of gentle persuasion at all times to find the greatest possible consensus behind each forward step we take.
- 2.4 This report seeks to provide a strategy for the future to assist the people who choose to make their lives in Scotland to determine the best route forward for our economy and society.
- 2.5 It is important that independence must never be seen as a magic wand or quick and easy step to success. Indeed, there is no pot of gold, black or otherwise, at the foot of the independence rainbow. But there is a toolbox and using it will mean taking responsibility for choices that seek to create a stronger economy, sustainable public finances and a fairer society. Independence is a means to those ends, I believe a necessary but not sufficient step to success. The choices that are then made about the country's strategy and how effectively they are delivered are what will determine success – we are our choices.
- 2.6 While that was true in 2014, lessons have to be learned both from the experience of that referendum and the events that have unfolded since. This means clear sighted analysis of the prospectus for independence and also, of the 'status quo'. Of course, it is no longer a status quo, not least because the UK is now following a path to exit the European Union

¹ Richard Holloway: Interview with Bryan Appleyard, The Sunday Times, 11 March 2012

² Donald Dewar, speech at the opening of the Scottish Parliament, 1st July 1999

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

- 2.7 This report focuses on challenges as well as opportunities. We must be candid about those challenges as well as optimistic about the opportunities. If people are to be persuaded of the case for independence, including reconvincing many of those who voted 'Yes' in 2014, they must be confident that the challenges are not being glossed over or minimised, but that there is a plan in place to address them. Hope must conquer fear, of course, but that hope needs to be grounded in clear-sighted reality and a rigorous plan. And in putting this together in this report, we have drawn on the best expertise we could find; Scotland, we think, has not had enough of experts.
- 2.8 This report argues that Scotland has an economic potential that far outstrips its current and longer-term performance. The ambition for the country should be to perform to the best of the small advanced economies in the world and in doing so make choices about the sort of society and economy we wish to live in. Bridging the gap between potential and performance is the purpose of this report.
- 2.9 To achieve this will mean challenging the way that all sides in our national debate approach the challenges and opportunities, and one another. Purposeful action must commence immediately and will quickly begin to reap rewards. But that action must be long term, inter-generational and cross partisan.
- 2.10 Whatever one's perspective on the constitutional position of Scotland, the UK and Europe, there should be a shared desire to achieve the full potential of the country. Our current performance and position is not 'as good as it gets' and we can, collectively, do so much better.
- 2.11 Our work represents the output of over 18 months of analysis and deliberation by the Sustainable Growth Commission. Our method has drawn on commissioned research and analysis from a range of experts and in particular an analysis of the best lessons from a benchmark group of 12 small advanced economies. From these lessons we make clear recommendations for action on growth, stewardship of the public finances and our future currency and regulatory position.
- 2.12 In summary we contend that:
- (1) We can lift the growth performance of the country to take living standards to equal the best small countries in the world over a generation;

- (2) Our public finances can be put right sustainably from the unsustainable position we inherit from the UK system at present. And we can do so in a way that continues to grow public spending while stewarding the growth position of the economy;
- (3) In terms of currency and regulation the transition through independence to a new Scottish system can be managed in an orderly fashion which maximises stability and contains risks to jobs and investment very effectively. Future choices on currency could be considered and earned, on terms that are made clear up front, once the economy and public finances are on track to the sustainable high-performance position our ambitions require.

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

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

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

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

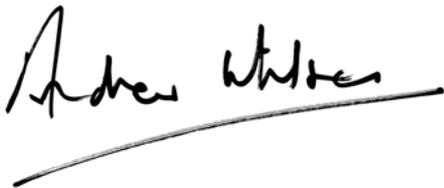
2.15 This report provides analysis and makes recommendations to aid policy development. It is now up to the policy makers to consider it. In the first instance, it is for the SNP which commissioned the report to consider it through its normal processes. I hope it is also of use and interest to the wider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

- 2.16 We know that not every detail will win the immediate support of all sides in the debate or even of everyone who already supports independence. That is inevitable and is not something we have shied away from. A point that was perhaps not always fully grasped in 2014 is that choosing independence does not mean signing up to every detail of a specific future policy prospectus in advance.
- 2.17 However, I think the report represents, for the first time, a systemic consideration of every part of the economic prospectus and seeks to connect major choices on matters on currency, public finances and, of course, economic growth. In doing so we judge that it represents the best possible route to achieving a sustainably successful economy and cohesive society.
- 2.18 It also represents a prospectus that recognises the transitions that are required between the inherited starting point and the creation of the sort of country we seek to be. A clear sighted and honest exposition of how to make this transition orderly is the very least that should be expected by those we seek to convince.
- 2.19 Moreover, it is also possible that many of our recommendations could be agreed and implemented in advance of independence either with existing or enhanced policy responsibilities for Scotland's Parliament and Government.
- 2.20 The aspiration of everyone should be to raise our growth and living standards to the level of the best performing economies. All policy recommendations should be judged against their ability to deliver this. The economic model and strategy that is selected could take any one of many forms currently working successfully around the world. But we must also be very mindful of the structure of the economy and society that we start with and learn every possible lesson that the realities of history have to teach us.
- 2.21 We recommend a 'Next Generation Economic Model for Scotland', designed to achieve cross-partisan support, which learns in particular from Denmark, Finland and New Zealand. The point though is to adopt and tailor a model for Scotland's unique challenges and opportunities.
- 2.22 We should maintain a keen and intelligent eye on the experience of other countries and work hard to bring that inspiration and evidence to bear on our own thinking and tailor our policy to our own unique conditions. We also have to keep pace with the reality of a fast-moving international trading and economic environment.
- 2.23 The real challenge we provide to many who currently do not support independence or enhanced policy control for Scotland, is that we believe that the current UK model is not sustainable. Taken together with the UK's approach to exiting the European Union, this represents a material risk to living standards in Scotland in the short, medium and long term.

- 2.24 What is undoubtedly the case, is that the current era represents a fundamental challenge to the global system in which the role of government itself is under scrutiny and reform is underway. While globalisation has improved the overall welfare of the world it is also true that the benefits have not been adequately shared. The health of the economy, in its simplest measure, boils down to the sum of all wages and salaries and all of the profits. The fruits of this are now unevenly spread by geography, gender and generation and in many other respects.
- 2.25 Partnership is needed to ensure that our strategic approach is cross partisan, inter-generational and purposeful. This will mean government, business, trade unions and wider civic society working on concert.
- 2.26 Considering the best way forward for Scotland in the face of all opportunity and challenge requires trade-offs to be considered and choices made. An honest exposition of what these are will benefit the quality of the debate and ultimately the sustainability of the choices we then make.
- 2.27 In the very simplest terms we can recognise a number of trade-offs implicit and explicit in the framing of the current debate which we contend require consideration and reframing. Some argue, for instance, that the estimated Scottish public finance deficit within the current system is an imperative to stay the same and renders a distinct autonomous approach impossible and unaffordable. In this report, we argue the opposite, that it is the very evidence of the reason for reform and that controlling how it is put right is far more preferable to having it done to us. Indeed Brexit, and in particular a hard Brexit, is likely to depress tax revenues and squeeze public spending across the UK.
- 2.28 Similarly, some effectively argue that lower growth within the limited large country model of the UK system is a price worth paying for the security and ‘certainty’ of the funding of the fiscal deficit. We disagree, fundamentally, and argue that purposeful effort to improve the growth performance and consolidate the public finances is a far more sustainable approach as the lessons of the best performing small countries suggest. Not least because Brexit and political decisions at Westminster mean there is no security or “certainty” at all that Scotland’s deficit will continue to be funded. But, also because that policy and approach is not producing anything like the potential outcome for the economy, living standards or social cohesion. The evidence demonstrates that smaller countries, partly because of their greater need to respond to global challenges, produce better governance, policy and therefore living standards.
- 2.29 Having a purposeful and clear point of view is critical to the leadership of the economic policy agenda. We must choose and make good our choices. Those choices must mean taking responsibility for the society and economy we create now and pass on to the next generation. It is for all of us who believe in the potential for a better country to inspire

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

- 2.30 Carrying on as we are now would represent a dereliction of our duty to both our own potential and that of the generations to follow whatever the constitutional choices we make.
- 2.31 What must be beyond doubt for all sides in the debate is that Scotland has the experience and skill to navigate the current climate and any independence process as well as any of the 193 current members of the United Nations.
- 2.32 We would start an independence transition with greater information certainty and existing institutions and competences than any other country that has ever made the choice. The conditions for success exist. Whether we choose to take the opportunity is a matter, as always, for the people who have made their lives here, to choose.

A handwritten signature in black ink that reads "Andrew Wilson".

Andrew Wilson
Edinburgh, May 2018

3 SUMMARY

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

- 3.1 Part A of the report considers the performance of the Scottish economy, set in the context of the global and UK economy and assesses the potential for improvement. This is done by drawing on the experience of the peer group of the 12 most successful small advanced economies and assessing the lessons that can be learned to make the most of Scotland's potential. This sets out some principles for a new Scottish economic model and long-term policy strategy. It then proposes a framework for a Scottish economy that is designed to match the performance of the benchmark small advanced economies. Based on that framework, a series of policy recommendations to support these growth aspirations now and with fuller policy powers are set out.
- 3.2 The approach is to grow GDP by focussing variously on productivity, population and participation (inclusive) growth – the three 'Ps' of economic performance. The focus on productivity is very important and has dominated much of the economic debate in recent years. However, we recommend an elevation of focus on population growth and participation as critical to short term demand as well as to the longer term health and well-being of our society.
- 3.3 To consider all of this we look at the evidence from the performance of the UK economy over recent decades, the approach and performance of our benchmark group of small advanced economies, and the underlying assets and strengths of Scotland and therefore its potential.
- 3.4 Our central argument is that Scotland should be seeking to emulate the performance of the best small countries in the world, rather than sticking to its current position as the best of the rest of the UK regions and nations outside of the south east of England.
- 3.5 We strongly believe that the balance of UK ambition and policy intervention in recent decades has been significantly to the disadvantage of both Scotland and the UK economy as a whole. The centralised 'big country' model which concentrates too much economic activity in London and the South-East region is holding Scotland and the other regions and nations of the UK below their potential. Some argue that this is a price worth paying if fiscal transfers take place as compensation. We fundamentally disagree.
- 3.6 Brexit is a clear and present danger. In the short-term, Scottish interests would be promoted by proper engagement between the UK Government agreeing to proper engagement with

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

- 3.7 We hope that this report helps to articulate an approach and way of thinking that then allows others across the policy debate to frame their ideas and contributions.
- 3.8 We have, quite purposefully, not yet tackled some of the other very substantial reform challenges that face economies everywhere that deserve to be the subject of detailed and focussed analysis. In particular the impact of artificial intelligence, automation and further technological advances merit a substantial national review and debate in and of themselves. Policymakers and leaders must think ahead to the sort of society and economy we will become and the implications of that for everything from education strategy to inequality and the overall role of government itself. Room needs to be found in the Scottish and UK discourse for such deeper and longer-term themes to be aired.
- 3.9 What is clear from the evidence of the most successful countries is that having a strategic approach that is unambiguous and agreed for longer term effort (as far as is possible) and cross-partisan (as far as possible), is a huge advantage. Partnership is needed between government, business, trade unions and wider civic society to ensure policy can be made sustainable. Economic success is built long term, over generations by sustained effort, close attention to evidence and feedback and clever agile short-term policy responding to prevailing economic conditions and competition.
- 3.10 None of the most successful countries that we have examined have underlying advantages over Scotland that suggest our aspiration to equal or exceed their performance is unreasonable. In fact, Scotland has many advantages that set the country apart in economic potential.
- 3.11 What is certainly true, however, is that the structure of Scotland's economy and society has not yet adequately transitioned from the fall-out of post war industrial restructuring, especially in the 1980s. This renders significant challenges for policymakers balancing the calls on limited resources for measures to alleviate the symptoms of underperformance, against calls for other measures to grow the scale and performance of the economy in a way that will tackle those symptoms at source. The pressures this has placed between and within generations, on demographic groups and regions are considerable. Enabling policymakers and those that hold them to account to take risks, act purposefully and elevate the long term national self-interest, is extremely important.
- 3.12 This report is by no means the last word on ideas for strategies and policies for growth, far from it. There are numerous such reports and policy ideas to draw on. We especially commend the report by Lord Heseltine "No stone unturned in pursuit of growth" for the

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

- 3.13 What we have therefore sought to do is provide a comprehensive attempt to learn the best lessons from the best performing countries and put that into a framework that is accessible, useful and useable by all. We make a series of specific recommendations and urge all participants in the economy and economic policy debate to engage positively.
- 3.14 What is clear is that there are no silver bullets or cleverly designed or as yet undiscovered routes to success. The key lesson amongst all is the need to think and act for the long term; frame a strategy and deliver to it.
- 3.15 Ultimately this is about the sort of country – society and economy – we want to become and believe that we can become. If many other small countries have succeeded, why not Scotland?
- 3.16 It is also important to consider all factors when assessing the true quality of life in a country. The relative cost of housing, quality of public services, amenity and culture all matter hugely. How we choose to live, behave and conduct ourselves define the country far more than the numbers. But that is for a broader debate that we hope the foundations provided by the work of the Commission can provide a basis for.
- 3.17 Ultimately all of the choices we face represent trade-offs. In this part of our report the evidence suggests that the best performing countries are aware of the need to respond to changes in the global economy but as a result have better governance and policymaking that produces better average growth and therefore living standards. Small economies perform better than larger ones consistently by around 0.7 percentage points per year over the last 25 years on average.
- 3.18 We hope that the ambition to be among the very best in the world is one on which all sides in Scotland’s debate can agree. Carrying on as we are now is unlikely to achieve this. The onus on all sides in the policy debate is therefore to accept the burden of proof lies with all sides. We have accepted our responsibilities in that regard with enthusiasm.

Key Points by Chapter: Part A

Economic Context

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

- 3.20 Scotland has very significant comparative economic assets and advantages, in terms of natural resources, the education and skills of the people who live in Scotland and sectors with existing and potential global competitiveness.
- 3.21 It is energy-rich with oil and gas resources, up to 25 per cent of Europe's tidal power potential and 25 per cent of Europe's offshore wind potential.
- 3.22 We have world-class universities, a world-wide reputation for premium food and drink products and our country has been named the world's most beautiful, boosting our outstanding tourism industry. We are at the cutting edge of games technology, photonics, life sciences, advanced manufacturing and other industries of the future.
- 3.23 Despite these abundant resources, other independent countries with the ability to tailor economic policy to their own needs have performed better than Scotland. The median income of the group of 12 small advanced economies³ is 14% higher in GDP per head; a gap of £4,100 per person. This shows what is possible for an independent Scotland.

The UK Economy Before Brexit

- 3.24 The economic debate was at the heart of the 2014 referendum⁴. That debate was predicated on the assumption that the UK would continue to be a member state of the EU.
- 3.25 A key argument from the pro-independence side was that the UK economy was unusually unbalanced – both in terms of geographical performance and inequality in income and wealth among UK citizens.
- 3.26 This report shows very significant regional disparity of performance in the UK. The gap in performance by local areas is by a distance the most unequal in Europe, with far too much economic activity and opportunity concentrated in London and the South-East of England.
- 3.27 The gap between rich and poor in the UK continues to be one of the largest among developed countries, with growing evidence that such inequality acts as a drag on economic performance.

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

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

- 3.28 A dependence on consumer debt fuelled spending for growth has been a consistent feature of the UK economy, is not sustainable and carries very significant risks.
- 3.29 The UK's export performance has been poor and with a falling share of the global market. The UK has – by far – the highest trade deficit in the EU.
- 3.30 Scotland performs close to the UK average in terms of economic performance per person but has not enjoyed similar levels of population and labour force growth.
- 3.31 If Scotland had matched UK population growth since 1980, the population of Scotland would now be 5.8 million, if it had matched the population growth of the other small European countries (such as Austria, Denmark, Finland, Ireland, Norway and Switzerland) there would be 6.1 million living in Scotland.

Brexit – Two Futures

- 3.32 If the gap between Scotland's real per capita income and the median of the small advanced economy group was closed, income per head would be 14 per cent higher. Closing the gap between Scotland and the best performers would increase incomes by half. Closing this gap would mean, in today's values, an additional £22 billion in additional GDP and a potential additional £9 billion in tax revenues.
- 3.33 The decision of the UK to leave the European Union will fundamentally change Scotland's economic future. Brexit will almost certainly widen, not narrow, the gap between Scotland and comparator countries.
- 3.34 The UK Treasury says Brexit will make the UK "permanently poorer". This is not a controversial claim. There is a widespread consensus among economists, with few exceptions, that leaving the EU will damage UK economic growth, productivity and job creation.
- 3.35 The Fraser of Allander Institute estimate a potential Brexit impact of the loss of between 30,000 and 80,000 jobs, the loss of between £3 billion and £8 billion in GDP and a real wages cut of £2,000, depending on the model that succeeds Brexit negotiations.
- 3.36 Scottish Government modelling shows an adverse impact on trade, productivity, population and foreign direct investment. And LSE's Programme of Brexit research suggests Scotland (as well as Wales and Northern Ireland) are already being disproportionately hit by the impact of the Brexit vote.
- 3.37 The already huge difference in economic performance between London and the South-East of England and other parts of the UK is therefore likely to increase.

- 3.38 This means it is essential to stimulate an inclusive, national debate on Scotland's economic future to find out whether a different, better path is possible.
- 3.39 Scotland's resources and talent, combined with good decision-making and the ability to tailor policy to our needs, can lead to improved economic performance and avoidance of the low growth future in a UK outside the EU. The growth aspirations here are structured over three time-horizons: (i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.
- 3.40 The long-term nature of the strategy should not diminish its urgency. It must begin now.

Insights on the Performance of Small Advanced Economies

- 3.41 Common themes in benchmark small advanced economies policy include a commitment to strong policy foundations (solid macro policy settings, innovation and human capital, and internationalisation), as well as a high degree of strategic coherence across these different policy settings, positioning the country to compete effectively in the global economy.
- 3.42 Small economies perform better than larger ones consistently by around 0.7 percentage points per year over the last 25 years on average.
- 3.43 This growth performance has meant the benchmark group of 12 small advanced economies has held its share of the global economy over past decades remaining competitive even with the integration of the large emerging markets. The share of many large economies, including the UK, has retreated substantially.
- 3.44 Small advanced economies have done well in terms of labour market performance, with relatively low unemployment, on average, a couple of percentage points under those of larger advanced economies.
- 3.45 On average, there is no clear margin between small and large advanced economies in terms of levels of labour productivity which is constrained in small economies by the small size of the domestic market; however the strong performance in the trading sectors offsets this. In this respect leaving the EU and Single Market would obviously act as a growth restraint for Scotland.
- 3.46 Small advanced economies also tend to do well on measures of the extent to which the gains from growth are broadly shared. Many small advanced economies, notably those in Northern Europe, have low levels of income inequality. Income distribution outcomes are

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

- 3.47 The overall performance of our benchmark group is significantly ahead of the UK and the large economies. Policy making is more agile and of higher quality because it requires to be.
- 3.48 Through history, there has been a strong relationship between periods of trade openness and an increase in the number of countries. Over the past 100 years, the number of independent countries rose from under 70 to just under 200 today.
- 3.49 Overall, small countries have effective, responsive governments, with a well-developed sense of strategic capacity, high levels of trust and social cohesion, and the ability to adapt in response to changing international circumstances.
- 3.50 Small competitively-strong economies are continuing to invest in key sectors and clusters, to help them develop positions of advantage in a more competitive and challenging global economy.
- 3.51 The levels of international engagement by small advanced economies are substantially higher than for larger economies and the growth in international economic activity has also been stronger. This is the case for both exporting as well as cross-border direct investment.
- 3.52 Large multinational firms play an important role in small advanced economies in driving international expansion.
- 3.53 However, increasingly, small advanced economies are investing in firm-level enterprise policy to support international expansion by indigenous firms. Export promotion agencies are increasingly working intensively with high-growth potential firms to accelerate their international engagement.
- 3.54 Small advanced economies take micro and macro policy foundations very seriously. Small advanced economies rank highly on the various indexes of the quality of policy and flexibility of business environment.
- 3.55 The strong performance of small countries is largely a matter of deliberate choice and management. It is the small advanced economies that have positioned themselves most appropriately for the challenges and opportunities of globalisation that have performed best. In contrast, those countries that did not engage with, and respond to, these global forces did not fare well.

- 3.56 Two fundamental lessons are clear: Scotland must become more engaged, not less, in the global and European economy in order to boost growth. And the opportunity to contribute to, and benefit from, that growth must be more widely shared.
- 3.57 In considering the future, the UK economic model is wrong for Scotland. Leaving the EU and the Single Market, hostility to immigration, concentrating economic activity in London and the South-East of England, low wages and tolerating a large gap between rich and poor can only depress growth and opportunity.
- 3.58 Our recommended starting point for a *Next Generation Economic Model* for Scotland is based on learning the lessons from small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. Drawing on all 12 small advanced economy case studies we are especially drawn to a hybrid of Denmark, Finland and New Zealand. Features of that model include; quality of governance; long term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location, placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective. The best of the lessons of Denmark, Finland and New Zealand are at the heart of this but many other countries can, of course, offer continued inspiration.

The imperative of population growth

- 3.59 Scotland has recently been transformed from a nation suffering from population decline to a country benefitting from net immigration for the first time in our recent history. Positioning ourselves with an outward focus will both increase opportunities for the next generation of Scots born here and ensure we continue to attract talent.
- 3.60 Given the demographic structure of Scotland, migration is critically important to population growth and also productivity performance. IMF evidence suggests a 1 per cent increase in the share of migrants in the adult population can increase productivity by 3 per cent long term.
- 3.61 Scotland must continue to attract people in order to increase our working population and our overall population. Migration is projected to account for all of Scotland's population growth over the period 2016-2041. Maintaining immigration is essential otherwise the number and proportion of people working and paying taxes will fall. The economic activity and employment rates of those born outside of the UK are higher than those in the rest of the Scottish population.

- 3.62 There are around 429,000 people resident in Scotland who were born outside of the UK, 8.1% of Scotland's total population. Of the UK regions and nations London has the highest share of its population born outside of the UK (38.3%).
- 3.63 The contribution of non-UK born citizens in Scotland to the Scottish economy is estimated at approximately £12 billion per year.
- 3.64 The 429,000 Scottish residents who were born overseas are associated with £4.3 billion of government revenue, including income tax and national insurance contributions. Government spending associated with Scottish residents who were born overseas stood at £3.0 billion. This suggests a net contribution to Scotland's public purse of £1.3 billion per year. The Polish born community alone is a net contributor of circa. £250 million.
- 3.65 We estimate that approximately £1.1 billion in exports in 2015-16 was attributable to overseas students studying in Scotland. Each student from out with the EU generated £26,811 in exports for the Scottish economy in 2015-16 and each student from within the EU generated £14,812. However, given that much of the spending of students is consumer spending in Scotland, like tourism exports these figures are not reflected in reported export statistics.
- 3.66 Overseas students in Scotland also make a net positive contribution to the UK Exchequer of around £2,500 per person per annum.
- 3.67 Policy should prioritise Scotland's rankings in the main world competitiveness league tables and related trade-offs considered and agreed for long term policy.
- 3.68 The attraction of economic migrants (from identified target groups) should be one of the top priorities of Scottish Government economic policy. Policies are recommended to remove barriers provided in UK policy and to incentivise talent to come to Scotland.
- 3.69 Tone and message matter every bit as much as policy specifics in driving sentiment and human behaviour in this area, the whole country must market itself as a welcoming home for new talent and overseas citizens already based here. We should seek to be the most talent friendly country in the world.

Participation & Inclusive Growth

- 3.70 There is an economic as well as moral imperative to improve participation and equality. A long-term cross partisan strategy is required.
- 3.71 International Monetary Fund and World Economic Forum studies identify a direct relationship between improved inequality and growth.

- 3.72 In income and gender pay inequality Scotland underperforms many of the benchmark small advanced economies to its economic, social and fiscal disadvantage.
- 3.73 The direct cost of inequality on the Scotland's net fiscal position is estimated at more than £6.4 billion per year.
- 3.74 The Joseph Rowntree Foundation targets a position where less than 10% of the population are in poverty at any one time. This would be a reduction of 50%, if achieved this could mean a saving of £1.6 billion to the Scottish public finances.
- 3.75 OECD data show that many small advanced economies have gender pay gaps that are less than half that of Scotland. Median full-time female workers in New Zealand are paid 94.4% what the median full-time male worker is paid, compared to 83.4% in Scotland.
- 3.76 If gender inequality in Scotland was reduced to the level of New Zealand, Scottish GDP would grow by £6.1 billion and the net impact on public finances would be a possible positive net exchequer impact of up to £2.5 billion.
- 3.77 Regional inequality within Scotland is less stark than within the UK but requires addressing.
- 3.78 More localised inequality also needs to be addressed, targeted at the groups in society who have faced significant barriers to full participation in the economy, even in times of economic growth. This will require concerted long-term action to ensure that no one is excluded from opportunities that the majority of us take for granted.

Productivity & Competitiveness

- 3.79 Increasing productivity growth in the Scottish economy will be crucial and will generate significant economic and social returns.
- 3.80 There is a widespread view that current economic development arrangements are not adaptable enough to respond quickly to new opportunities for the Scottish economy. Brexit is forecast to worsen productivity.
- 3.81 All of the approaches to increasing productivity growth require an increase in levels of investment in the Scottish economy, on improved technology, increasing capital intensity, better working practices and policies that encourage the growth of high productivity sectors.
- 3.82 International competitiveness rankings matter and should be elevated in policymaking, target setting and debate. Agreement should be sought on how Scotland can best achieve the required improvements in relative production costs and prices. One way is through

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

- 3.83 An increase in trade share of GDP equivalent to 1% of GDP can increase productivity in the economy by 0.4%. More specifically, the benefits to labour productivity and how that feeds through to wages are estimated to be 2-3 times as much.
- 3.84 Access to international markets is essential. The ability to integrate with international supply chains is critical for competitiveness and to attract foreign investment. The discipline of international competition can also help to drive innovation and new ways of working
- 3.85 While there are many successful Scottish exporters, Scottish exports are more dependent on a small number of sectors that employ relatively few people.
- 3.86 Scotland and the rest of the UK have a mutual interest in maintaining a close trade and investment relationship that benefits both. But if the Scottish economy is to realise its full potential, then we must build stronger direct trade and investment links with other European countries and the rest of the world.
- 3.87 The potential Brexit damage to trade relations with Europe – and the risks to trade relations with other countries – means that Scottish dependence on the UK market is likely to grow after Brexit if Scotland remains part of the UK. This narrowing of Scotland’s potential markets will be to Scotland’s material economic disadvantage. That this is seen by some as a case for maintaining the current model strikes us as demonstrating a remarkable lack of concern and ambition.
- 3.88 Maximising frictionless trade and market access with the rest of the UK and with Europe is of critical importance to the performance of the Scottish economy in the short and long term.
- 3.89 Increasing overseas exports from 20% of GDP to 40% of GDP would be a reasonable target to set in order to close the export gap with small advanced economy benchmark countries, implying an increase from under £30 billion to more than £60 billion. This could deliver a productivity boost of 8% of GDP and would be expected to generate additional taxation revenues of some £5 billion each year.
- 3.90 In Scotland, as in most other small advanced economies, improvements in productivity will come in myriad small advances, but a few major reforms would make that process a great deal easier – for example finding ways to encourage capital (total factor) productivity and repair the long-standing investment rate deficit.

- 3.91 Establishing a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful, in particular ways in which policies can be used to bring these opportunities to reality in practice. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model if appropriate.
- 3.92 The Anholt-GfK Roper Nation Brands Index examines the image of 50 nations. Scotland's score (61.8) and rank (17th) on the index show that Scotland already has a strong national brand. Across all dimensions, with the exception of exports, Scotland is ranked within the Top 20 countries indicating that there is room for improvement in the exports dimension.
- 3.93 Digitalisation will continue to have an immense impact on the world economy in the coming decades, offering potential in every sector. The digital sector has grown markedly over the past five years and must be continue to be a priority growth sector for Scotland, given its potential long-term significance to the wider economy and also to the ability it provides to widen participation and globalisation in a country of Scotland's geographic position and structure.
- 3.94 Higher Education Research & Development (R&D) significantly outpaces the UK and EU averages and lags only Denmark, Switzerland and Sweden. Scotland's university sector is a key comparative advantage for any growth strategy. Internationally Scotland's scientific outputs Scotland ranks top, and second to the Netherlands in terms of their influence. However, business R&D investment lags significantly behind EU, OECD and UK averages for both the government investment and business sectors. Improving this measure in key to overall productivity growth, higher investment, and strengthening the competitiveness in the Scottish economy.
- 3.95 Even within countries and industries there can be large gaps between the most productive and others. The diffusion of knowledge is as important as pushing the boundaries of knowledge. Changes in technology resulting from science and innovation accounted for one-third of productivity growth that took place in the UK between 2000 and 2008.
- 3.96 There is a positive and leading role for the state in the promotion of R&D and innovation. Building on the Scottish Government's Can Do Innovation Forum, additional initiatives are required to improve commercialisation performance and enhance the role of workplace skills in innovation and the creation of a learning economy.
- 3.97 Infrastructure is critically important and can deliver significant economic returns on investment. The World Economic Forum's Global Competitiveness Index ranked the UK only 28th in the world on quality of infrastructure. An Infrastructure Commission is urgently required along with a longer-term commitment to increased investment.

Summary of Main Recommendations – Part A

- 3.98 Throughout the report a number of recommendations are made. We encourage all of these to be considered immediately in terms both of what can be achieved now. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached, and co-operation sought for policies that would benefit Scotland's performance long-term. However, given the difficulty in persuading a flexibility and pragmatism of approach this may prove impossible. It is clear to us that in order to realise Scotland's potential the normal powers of independence are required.
1. **National Economic Strategy:** The creation of an overarching national economic strategy that (as far as is possible) focuses on long term goals and secures broad cross partisan and sectoral support should be the central goal of growth policy. This is and of itself a necessary but not sufficient factor for success. **Growth goals:** The Strategy should include globally ambitious growth goals, to i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group.
 2. **Next Generation Economic Model:** A national debate should be commenced on the model we seek for the long-term. Choosing matters and the manner of choosing helps determine the sustainability of the choice, since the central lesson from the success of small advanced economies is that they have achieved consensus about long-term priorities and have a collaborative approach to pursuing those priorities. Our recommended starting point for that national debate, is based on learning the lessons from benchmark small advanced economies and applying them intelligently to Scotland's circumstances, needs and opportunities. The features of that model (leaning especially on the lessons of Denmark, Finland and New Zealand) include: quality of governance, long-term cross partisan strategy, a focus on innovation, being a competitive location for international investment, exploiting Scotland's resource endowment, an export-orientation, migration-friendly, where flexible labour markets combine with fair and progressive work and active employment policies, maintaining a highly skilled workforce with transferable skills, using taxation as a tool for economic development but not competing as a low tax location, placing inclusive growth at the heart of the strategy and viewing quality of life as both an asset and objective.

3. **Delivering Cross-Partisanship and Collaboration:** A cross-partisan collaborative approach to policymaking against the long-term national strategic framework should be institutionalised. Direct engagement across sectors, business representative, employee representative and other policy groups should be institutionalised to ensure that the national economic strategy remains a vital and dynamic part of policymaking.
4. **Identifying comparative advantage and strategic priority sectors:** while we are leery of the idea of ‘picking winners’ a clear choice should be considered in identifying and promoting those areas (rather than particular firms) in which we judge the Scottish economy to have sustainable comparative advantage. The process of selecting strategic priorities should be a key output of the process identified in (2) and (3).
5. **Productivity Commission.** We recommend the establishing of a Productivity Commission in Scotland, to identify opportunities for productivity improvement would be useful. Adopting a fixed-term model, as in Denmark or Norway, would be an easy way to start – with an option to establish a New Zealand style Productivity Commission model if appropriate.
6. **Frictionless borders and market access:** Securing frictionless borders with the rest of the UK and EU should be a top strategic priority of the Scottish Government. Brexit places a material risk on Scotland’s access to export and import markets and the free movement of people, capital, goods and services and must therefore be resisted vigorously. The alternative will be a severe reduction in living standards, growth and employment levels. Scotland has more at stake than most small nations in the coherence of the process of fair global integration. The lessons of the Scottish enlightenment and history since must be kept front of mind by all.
7. **Population growth:** Targeting a growing population of working age and the attraction of talented migrants should be a top priority of Scottish Government economic policy and marketed vigorously to the rest of the UK and the world. Scotland should seek to be regarded as the most talent friendly country in the world.
8. **A new ‘Come to Scotland’ package** should be created with a package of incentives including:

- A 'transition relief' package of tax incentives to reduce the cost of moving to Scotland, and for graduates of Scottish Universities to stay on should be the headline instrument.
 - A reduced capital threshold for investors who are required to provide this
 - A reduced investment threshold for business start-ups
 - A new visa system benchmarked on the most efficient and easy to use in the world
9. **Marketing of 'Come to Scotland':** The marketing of this package and the overall approach should be a major part of the country's international and UK marketing investment and the communications strategy for the internationally facing Scottish agencies. As far as possible the intention will be to secure cross partisan support for the whole approach which also attracts engagement from our major employers, exporters and universities. The budget should reflect the priority as should the engagement of senior Ministers and officials.
10. **Celebration of the contribution of migrants:** A complimentary programme of internally focused public engagement on the contribution of our migrant and 'new Scots' communities should be embedded in the work of the Government, Local Authorities and across Parliament.
11. **International Students and Graduates:** The attraction and retention of international students should be a priority of policy and changes made immediately to alleviate the constraints caused by UK policy. These changes should include both visa changes to allow more students to stay in Scotland long enough to secure employment appropriate to their qualifications and tax incentives for the first three years of employment (in recognition of the social, economic and exchequer contributions already made).
12. **International Government and Multi-national Organisation Strategy:** One of the existing internationally facing elements of the Government or indeed a combined international department or agency should be tasked with creating a strategy for engagement and transitioning of the staff of international governments and multi-national organisations to Scotland. As well as providing a great home for countries and organisations that wish to engage with Scotland the strategy should aim to provide a home for as many international facing organisations in function or headquarter as is possible. A warm

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

13. **A Commission on Gender Pay Equality** should be created with a remit to consult and engage across the economy and consider the best policies and incentives to produce a purposeful reduction in the gap with the performance of the best performing small advanced economies, especially New Zealand.
14. **The JRF target of a 50% reduction of poverty to 10%** of the population should be agreed within a stretching but achievable time frame. This policy should be elevated to central strategic importance in the overall strategy and prioritised accordingly in resource allocation.
15. **Long term strategy on participation and inclusion:** agreement should be sought on the central importance of participation and inclusion to sustainable economic growth and a framework set up to oversee long term policy intervention and resource allocation from e.g. The Fund for Future Generations. Whilst inclusive growth is already a policy priority of the Scottish Government, the full powers of independence will provide an opportunity to expand the priority across all policy areas that can contribute, including fiscal policy, industrial strategy, social security, economic participation and fair work, education and skills and community engagement. **Strategic communication on the costs of inequality** should be a priority of government and political strategies. It is important to build a wider public understanding of the realities of the short and long-term costs so that agreement and support can be obtained for longer term interventions.
16. **Labour markets and flexicurity:** Scotland can learn from Denmark and move to a flexicurity model, with flexible labour markets but without the insecurity the UK benefits system promotes. This would be expected to deliver lower unemployment, particularly lower youth unemployment and enhance productivity by stabilising investment incentives. We recommend a consultation of how a move can be made to establish a Scottish flexicurity model.
17. **Competitiveness rankings:** Improving the rankings of Scotland in the main competitiveness rankings should be a core long-term aim of economic policy and the trade-offs involved considered and solutions agreed for the long term.

18. **Competitive Business Taxation:** As part of the review of taxation recommended in Part B we recommend that the impact of business taxation on growth performance is carefully assessed. We are interested in the potential to tailor the Dutch R&D tax credit scheme, enhance incentives for longer term equity investment and improve capital allowances. While we do not consider that competitive use of profit taxation (corporation tax) is an optimal strategic tool, we do recommend that the headline rate of corporation tax should not rise above the level prevailing in the rest of the UK. As with all taxation the impact of the overall structure on both the tax base and revenue generation should be carefully assessed to ensure the more effective system is deployed.
19. **Engagement of International Companies and Sectors:** organisational capacity should urgently be designed and recruited to create and support sector facing business Ambassadors, building on and increasing the prominence of the Global Scots network. This is intended to create a world class dialogue and engagement with those major companies located in Scotland or considering investing in a presence in Scotland to ensure opportunities are maximized and risks mitigated.
20. **Improved data and analysis:** There are gaps in the data that are available on Scotland's trade balance, and on the wider balance of payments position which should be addressed in the short so that the evidence is available on which decisions on policy and assessments of its success can be based. This is an immediate priority.
21. **Infrastructure Commission:** An Infrastructure Commission should be established to provide strategic advice, based on a research programme, to align investment with long term economic development aspirations. This should engage across sectors to seek a national agreement on the long-term priorities and plan. A significant increase in annual investment should be costed and the best means of delivering it identified. If 0.8% of GDP is identified as a go-ahead optimal steady state by some, there is a strong case for a significant increase in this in the short to medium term to ensure catch up in digital and physical infrastructure which will further carry economic benefits that could secure the 'pay-back' to investment in due course.
22. An **Export Growth Strategy** should be created urgently in consultation with the main exporting sectors, companies and potential exporters especially in smaller companies. The aim of this strategy must be to dramatically increase the value of exports overall

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

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

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

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

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

25. **Universities Growth Strategy Review:** We recommend a central role for Universities in Scotland's growth strategy and an immediate review of the policies that are required to help them maximise their contribution. This should be led by a combination of academic, investment, business and policymakers.
26. **Government Led Innovation Review:** There should be a policy review to assess the impact of previous interventions and to identify the policy requirements to close the R&D gap, improve the commercialisation performance and identify the role of workplace skills in innovation and the creation of a learning economy. Tax measures such as a Dutch-style R&D tax credit scheme and need for an innovation agency such as Finland's Tekes should both be subject of feasibility studies.
27. **Top 5 Strategic Development Projects:** at any one point in time we recommend that the Scottish Government, Local Authorities and Economic Development agencies should combine to select the top 5 strategic sites for urgent economic development and devote leadership effort and resource to fast-track them. These are likely to be in or around the main cities where the anticipated return on investment is greatest and likely to unlock greater economic activity. The focus of these projects is likely to combine infrastructure, transport and commercial property and residential development in some combination. The Infrastructure Commission could lead the process of selection and oversee delivery. Hub airport development and the opportunity for a freight hub could be specific opportunities to investigate further.
28. **Scottish National Investment Bank:** We support the creation of the SNIB and recommend that the bank participates with other investors on long-term risk bearing projects requiring equity investment and return. We further recommend that this policy move is considered alongside a more comprehensive review of policy in this area and the organisations and structures that deliver it from local government to national agencies. Close co-ordination with the British Business Bank and its investment priorities

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

29. **Housing and Growth:** A target should be set for all tenures of housing construction to align to broader migration and population strategy and the development of the planning process. In particular all options should be considered to ensure the investment is made in high quality housing that is far more affordable at all levels than at present. Housing should be seen as an integral part of economic and competitiveness strategy.
30. **Stop Strategy:** It is a relatively simple task to identify more tasks, resources and initiatives that any organisation must engage to improve its performance. It is far more difficult to ensure it stops doing peripheral activity or less impactful work. As part of the economic strategy it is critical that this is a work stream that is prioritised and resourced under senior leadership and governance.

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

- 3.99 Part B of the report considers the public finances and the governance and strategy required to ensure they are managed sustainably and with credibility, predictability and transparency. It makes recommendations on the strategy to manage them sustainably and put a credible and respected governance framework in place purposefully.
- 3.100 This is critically important for any country and especially important for a newly independent country as it transitions to its new governance framework. Those who are required to contribute, or manage, taxation revenues deserve as much foresight and insight on what they will be asked to pay and how. And, of course, the providers of debt finance to sovereigns require comfort that contractual commitments made to them will be honoured and underpinned by credible long-term governance and policy.
- 3.101 For the purposes of our analysis we have chosen a particular year, commencing 2021-22, as this is the end of the current planning horizon. This should, in no way, be taken as a target date for an independent Scotland. The decision on when to hold an independence referendum is clearly not one for the Commission. However, choosing a specific year aids the analysis as it allows illustrative numbers to be used. . The choice of starting point is not relevant for the overall approach.
- 3.102 The analysis then examines governance examples and experience from our benchmark group of small advanced economies around the world and makes a series of recommendations for the consideration of the First Minister.
- 3.103 Clearly the policies undertaken by any independent Scottish Government will depend on the choices made by the electorate in choosing their government. What the Commission's work seeks to do is provide a framework against which future choices may be made, especially through the first five to ten years.
- 3.104 Whatever it inherits financially on day one of independence it is critical that the Scottish Government moves purposefully to establish credibility and stability in the public finances as it will, for the first time, be going directly to debt markets to seek funding.
- 3.105 As things stand this will require a clear strategy to get any inherited deficit to manageable levels, in an orderly fashion, over a period of time that is sensible. It will also require a clear policy for the on-going containment of debt. Getting this right is one of the core pillars of creating the success of the newly independent country and its economy and the living standards its citizens enjoy.

- 3.106 In managing this transition, it is also important that the Scottish Government is careful about the role of public finance policy in stewarding and contributing to the broader economic performance of the country. We can observe from the policy performance of the UK government in recent years that there is a risk that a counter-productive impact on growth can result from mistimed or poorly considered budget choices. It is a truth that bears repeating that managing the public finances is not a zero-sum game of taxation and spending. The critical underpinning is the health of the economy and tax base. The health of the economy over the longer term should be uppermost in the minds of policymakers when making decisions about the budget in the short term and in determining the best course for fiscal sustainability.
- 3.107 That is not to say that there is any easy route to fixing the public finances from the current model from which they are inherited, there is not. But there is material value – as the evidence from the small advanced economies demonstrates – from tailoring policies to the Scottish economic interest while purposefully securing the credibility we require in creating a sustainable base for the public finances.
- 3.108 The recommendations set out in this part of the report do not rely on increasing the growth rate. However, there is no doubt that increasing the long term rate of growth would make the task of fixing the public finances considerably easier. Realising the ambitions set out in part A of this report would mean that the targets set in part B would be achieved earlier and a wider range of options would be available for longer term fiscal management.

The Politics of Scotland’s Public Finances

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

- 3.110 Therefore, for our purposes in this report we use the latest Government Expenditure and Revenue Scotland 2016-17⁵ as our starting point and project this forward leaning where we can on independent analyses such as the Institute for Fiscal Studies, John McLaren's Scottish Trends⁶ and the Fraser of Allander Institute.
- 3.111 This should ensure that the initial assessment of the 'starting point' is non-controversial. We then make proposals for policy that would not be dependent on any one growth outcome although, obviously, the better the growth performance the better the public finances.
- 3.112 What is undoubtedly true is that the current position of the country's public finances is an imperative for change rather than staying the same. And it is a reflection of the policies and structures that have created the scale of the estimated deficit as it stands, rather than on those that would seek to put it right. And, of course, this analysis can make no assumption about the ability of the Scottish Government to tailor policies to secure faster growth and therefore, reduce the deficit.
- 3.113 In political terms, we present a choice for making Scotland's public finances sustainable, purposefully and by our own efforts. It is for others to then judge whether this is preferable to having them ordered in the same manner that got us to the current under-performing position in the first place.
- 3.114 In addition, the prospect of an extreme Brexit, with Scotland out of the EU and Single Market as part of the UK, is almost certain to make the situation worse, with tax revenues depressed and the very real possibility of a falling working population.
- 3.115 Given the nature of Scotland's economy, society and geography there is no doubt that the challenges facing the country are distinct from many parts of the rest of the UK. Economies that are resource rich with a large landmass and a relatively small population should be able to steward their resources in a way that secures sustainable revenue sources.
- 3.116 The opportunity in all of this, for a Scotland with the fuller powers of an independent country, is that it can purposefully address its challenges while taking far greater benefit from its opportunities. Culturally, having rounded responsibility for growth, revenue and expenditure, and a credit rating, should enhance the depth of the policy debate to the benefit of all.

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

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

- 3.117 Finally, a word on North Sea Revenues: Like the deficit discussion the debate on North Sea Revenues has been framed negatively over the last forty years and more to the detriment of its effective stewardship. It has long been SNP policy to establish a Fund for Future Generations. Successive UK Governments have failed to do this. Looking forward it is our judgement that windfalls such as those that occur from the depletion of scarce natural resources should be treated as windfalls and not depended upon for recurring annual commitments. We have proceeded on this basis. Recent investments in the North Sea and the recovery in oil prices suggest an independent Scotland should be able to reap the long-term benefits of oil revenues for many years to come if they are stewarded sensibly.
- 3.118 Taken together this report should give everyone considering the future of Scotland and its public finances a sense of confidence that the country has both the imperative and wherewithal to manage itself with far greater ambition and sustainability than it has been over the last few decades. How we collectively choose to equip ourselves to achieve this is a separate debate. That this is doable and must be done, should be beyond doubt.

Key Points by Chapter: Part B

Scotland's Public Finances

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

Annual Solidarity Payment

- 3.120 An agreement should be sought for a mechanism for Scotland to pay a reasonable share of the servicing of the net balance of UK debt and assets.
- 3.121 This same mechanism could also include payment for continuing shared services and co-operation for example in the area of international aid for a limited or extended period.
- 3.122 We strongly recommend that the tone and approach of Scotland to the rest of the UK in those discussions should be informed by the recent and on-going difficulties created by the UK Government's approach to Brexit negotiations.
- 3.123 Our goal in advance of any independence choice and beyond should be to maintain a relationship that is respectful and as close and positive as between any countries anywhere.

Public finances: assets and liabilities

- 3.124 The sustainable management of national debt is mission critical to the UK, as it is to any country. Scotland is no different. Any sustainable government policy should be informed by an appreciation of the assets and liabilities passed to future generations.
- 3.125 Data is available from the UK government on assets and liabilities held by the public sector across the UK. Scotland's per capita share of the UK's non-current assets was £115 billion in 2015-16. After taking account of assets already located in Scotland and (non-pension) liabilities, there would be a net positive balance of £26 billion.
- 3.126 The fair and equitable division of these assets and liabilities will be the subject of agreement in the event of a positive independence choice. The UK Treasury confirmed in 2014 that existing UK debt instruments remain the responsibility of the continuing UK government. The UK's debt will therefore remain the responsibility of the UK Government after Scotland becomes independent. By definition, an independent Scotland will start with zero debt. The strength of that position should not be underestimated. However, an independent Scotland could choose to agree to contribute to the servicing costs of a fair and reasonable share of UK debt (net of a share of assets).
- 3.127 A negotiated balance to be serviced by the Scottish Government should take account of the balance of assets and liabilities as the UK currently argues in its negotiations with the European Union. We recommend a balance is paid annually to service UK debt instruments and set out our assumptions based on the data we have available. However, we would expect the true value of assets and liabilities to be examined and debated with greater rigour in advance of agreement being reached.
- 3.128 For the purposes of our report we take a conservative estimate based on OBR projections and the balances noted and assume an annual debt servicing charge of £3 billion (1.6% of GDP in 2021-22). However, this will fall as a percentage of GDP over time, as a result of inflation and economic growth.

Understanding Scotland's inherited fiscal position

- 3.129 The existing Government Expenditure and Revenue reports for Scotland estimates Scotland's position within the UK. That is our starting point for analysis. The latest report for 2016-17 identifies a Scottish deficit of 8.3% of GDP.
- 3.130 Taxes raised in Scotland are sufficient at present to fund all devolved services plus welfare and pensions.

- 3.131 Scotland contributes substantially to UK tax revenues. It is striking to note that, if London and the South East is excluded, Scotland (excluding oil and gas revenues) contributed 12.6% of the revenues, with 11.3% of the population share, in the latest regional tax statistics.
- 3.132 We assume North Sea revenues at zero for the purposes of our analysis. That does not mean we are anticipating no revenues. In fact recent investment and revenue projections have been positive. Rather, we recommend that windfalls such as from oil are not allocated to current expenditure but are set aside in a Fund for Future Generations, potentially managed through the Scottish National Investment Bank, for investment in inter-generational projects.
- 3.133 Approximately 40% of government expenditure allocated to Scotland is by the UK Government.
- 3.134 From 8.3% in the latest estimates it is anticipated on the basis of OBR and other independent forecasts that the GERS estimate of Scotland's deficit would be 7.1% of GDP by 2021-22. This would have to come down. However, it should be noted the UK has had a deficit at or above this level in six of the last ten years.
- 3.135 In making comparisons between the possible position of an independent Scotland and the position if Scotland was to remain within the UK, policy choices by the UK Government, not least to leave the EU, which will impact on tax revenue and spending, must be considered.
- 3.136 The current planning period suggests a 6% cut in the Scottish budget by 2020-21 by the UK Government in addition to the 5% real terms cut experienced since 2010.
- 3.137 The UK Government's intention to leave the EU and European Single Market is expected to lead to slower growth, with substantial downward pressures on spending.
- 3.138 Scottish Government analysis shows that Brexit could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030 compared to remaining in the EU.
- 3.139 The Annual Solidarity Payment is modelled at around £5 billion including debt servicing contributions, 0.7% GNP contribution for foreign aid and a further £1bn set aside for other shared services.
- 3.140 Scotland's replication of UK budget spend, currently allocated to Scotland in a number of areas, is assumed to be unchanged for our analysis including welfare, pensions, economic development and scientific and university research funding.

- 3.141 The defence budget is assumed at an initial 1.6% GDP, significantly ahead of the small European country average (1.1%) and the 8th highest in NATO. But it represents a saving on UK plans currently allocated to Scotland and presents spending multiplier opportunities for expanding the Scottish economy.
- 3.142 Two expert reviews recommended: Comprehensive Review of Inherited UK Spending programmes; Standing Council on Scottish Public Sector Financial Performance.
- 3.143 We have chosen a specific year, 2021-22, to illustrate the potential starting point of an independent Scotland and a subsequent deficit reduction plan. This should in no way be interpreted as a target date. Rather, choosing a particular year as an illustration allows for realistic forecasts to be made and a better understanding of the choices available.
- 3.144 As a result of the above analysis we anticipate that in 2021-22 the actual inherited deficit would be, on very conservative assumptions and an acceptance of the GERS analysis, 5.5% of GDP. The difference is explained by the savings from defence (0.4%) and UK central programmes (0.8%) and the impact of net assets/liabilities on the anticipated debt servicing element of the United Kingdom Annual Solidarity Payment (0.4%). This is further adjusted to 5.9% of GDP to exclude North Sea Revenues. This would be the anticipated starting point without any significant policy changes or ambitious growth assumptions.
- 3.145 This analysis depends on existing UK and Scottish Government published data that will vary over time. However, the direction of travel and broad position detailed should as closely approximate to anticipated reality as any government budget planning can be.

Set-up costs & invest to save opportunities

- 3.146 Total set-up costs to establish departments and agencies of around £450 million over 5 years, or £90 million per year for 5 years, based on the analysis of Professor Patrick Dunleavy of the London School of Economics.
- 3.147 Most of these costs would be associated with establishing four new bodies: a defence force and associated defence ministry, a foreign affairs and trade department, a security and intelligence agency, and a central bank and financial regulator.
- 3.148 Additional civil service personnel of around 4,100, an overall increase of public sector employees of 1%. The costs of additional personnel based in Scotland will have no additional costs (other than those included in transition costs) since these staff are paid for by Scottish taxpayers already, but based elsewhere in the UK.
- 3.149 Transition costs recovered within 6 years, from additional taxation revenues from the transferred personnel and activity.

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

Fund for Future Generations

- 3.151 All future North Sea Revenues should be set aside in a new Fund for Future Generations, along with any other windfalls such as asset sales or one-off revenue raisers.
- 3.152 Such a fund could be established within or invested via the Scottish National Investment Bank, currently being established by the Scottish Government.
- 3.153 The UK Government has received around £328 billion in real terms revenue from the North Sea production over the past 40 years.
- 3.154 The role of the Fund would be different in scale and ambition from Sovereign Funds that anticipated the oil boom such as in Norway (the Norwegian fund is worth around £750 billion).
- 3.155 The focus of this Fund would instead be on risk bearing by the public sector, and on exploiting inter-generational opportunities in the areas of Inclusive Growth, Transformative Innovation and Infrastructure and the Green Economy.
- 3.156 Further work is required on the detail of its remit and governance.

Fiscal framework and governance: international evidence

- 3.157 There is a wide variety of evidence of how other small advanced economies have reduced deficits to a healthy and sustainable position. Indeed, many of the fiscal challenges experienced by those economies represent far greater problems than would be inherited by Scotland on our analysis. Scotland's fiscal starting point is challenging, but it is a proposition that is fundable; and making it quickly sustainable is both achievable and essential whether Scotland is independent or not. The real question is how that is best achieved?
- 3.158 OECD evidence demonstrates average consolidations from fiscal deficits of 7% to 1%, in comparison to Scotland's anticipated starting point of 5.9% to a target of less than 3%.
- 3.159 In general, small advanced economies pursue policies of more prudently managed debt and deficits than larger countries.

- 3.160 Small advanced economies tend to respond more quickly and effectively to economic shocks than larger economies.
- 3.161 Scotland should benchmark itself against the small advanced economies it wishes to emulate in its fiscal policies and governance, rather than against the UK which is not a prudent or successful example.
- 3.162 Scotland should also learn the lessons of both international examples and recent UK policy history by tending carefully to the impact of any deficit reduction on growth performance. Scotland should explicitly reject the austerity model pursued by the UK in recent years. Scotland needs to focus on both the real economy, and putting finances on a sustainable footing, as dual fiscal goals.
- 3.163 IMF evidence suggests a gradual pace of fiscal adjustment is only credible if embedded in a medium-term strategy buttressed by strong budget institutions.

Supporting institutions: evidence from small advanced economies

- 3.164 The structure and design of fiscal policy and governance matters for both sustainable public finances and economic growth. We look to the evidence of successful small advanced economies.
- 3.165 There are three types of supporting institutions that contribute to successful fiscal management: credible rules, targets and reporting; disciplined budget allocation processes; a structured approach to the government balance sheet.
- 3.166 International evidence demonstrates that such institutions, with respect for rules and targets, can anchor expectations and build credibility. This is critical for creating sustainable and lowest cost funding of public borrowing.
- 3.167 International examples are outlined in this report. Long term fiscal targets are recommended with clear guiding principles. A path for fiscal sustainability should be laid out clearly. Clear reporting and transparent accountability arrangements should be put in place.

Budget process

- 3.168 Robust budgetary decision-making is a necessity for meaningful government control over fiscal aggregates. The international evidence demonstrates that the budget process matters.
- 3.169 Evidence suggests that the budget process is at least as important as the rules themselves.

- 3.170 Small advanced economies perform better on OECD measures of high performing budget processes than large economies. There is increasing consensus on best practice across developed countries.
- 3.171 The Scottish Government should aim to strengthen the decision-making process, increase the quality of resource allocation and consider new tools such as a systematic process of structured spending reviews across major spending areas, bottom-up. The best performing countries (such as Denmark) should provide the benchmark.

Taxation system: principles and strategy

- 3.172 Borrowing on the work of the Scottish Government's Fiscal Commission Working Group we highlight the issues and opportunities for the taxation system in Scotland and recommend further work.
- 3.173 The decisions that are taken by government on the design of taxes and tax rates set should take account of the likely economic impact on the economy, including on behaviour of individuals and on businesses. This should include regard for maximising revenues, since increasing (or reducing) rates does not always lead to increased (or reduced) revenues; taxpayers can often change behaviour as a result of the changes made.
- 3.174 A comprehensive review of the Scottish taxation system beyond income tax is recommended drawing on the best global expertise and experience with a view to recommending reforms to improve simplicity, neutrality and flexibility.
- 3.175 A cross-partisan approach is sought.

Managing the government's balance sheet

- 3.176 Substantial value to governance and finances will flow from effective management of the public sector's portfolio of assets and liabilities; and its balance sheet. This does not mean the privatisation programmes such as those that the UK has pursued, but maximising value to the public purse of assets it holds.
- 3.177 The IMF estimates developed world balance sheets are commonly circa. 70% of GDP. The UK balance sheet is smaller and for many countries the assets outweigh the stock of public debt.
- 3.178 Better allocation of capital should be a priority at all times. A good understanding of the balance sheet gives the most informative measure of financial sustainability.

- 3.179 Examples are examined from small advanced economies to better allocate capital and assets and manage debt and risk.
- 3.180 Scotland should quickly establish a best in class Debt Management and Assets Office, with consideration being given to allocating broad aggregate balance sheet responsibilities to this institution.
- 3.181 A comprehensive and accurate inventory and valuation of assets and liabilities held by the Scottish Government and public sector should be undertaken and maintained.
- 3.182 Opportunities for capital release into the Fund for Future Generations should be reviewed every 3 years.
- 3.183 An on-going and robust system for asset management and reporting should be created.

Creating a credible and sustainable fiscal framework & policy

- 3.184 Target a deficit value of below 3 per cent within 5 to 10 years.
- 3.185 National debt should not increase beyond 50% of GDP and should stabilise at that level.
- 3.186 Borrow only for public investment in net terms over the course of the cycle.
- 3.187 During the transition period real increases in public spending should be limited to sufficiently less than GDP growth over the business cycle to reduce the deficit to below 3% within 5 to 10 years. At trend growth and target inflation rates this would mean average annual cash spending increases of above inflation in contrast to the Scottish budget experience under the UK regime of recent years and that scheduled for the remainder of the current planning period.
- 3.188 The impact of fiscal management on growth must be tended to and it should be noted that this rule will apply over the business cycle. This means that in periods where growth is expected to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth.
- 3.189 Governance recommendations from preceding chapters should be delivered swiftly and purposefully.
- 3.190 Initial premiums on borrowing costs compared to the UK are not anticipated to be problematic but the target of policy should be to reduce the gap towards small advanced economy benchmarks. An assumption is made that initial debt interest costs could be 100bps above UK levels, the level estimated by the ratings agencies in 2014.

- 3.191 10 year debt accumulation is not anticipated to rise over 40% of GDP. Scotland's commitment through the Annual Solidarity Payment on UK debt servicing would affect deficit rather than debt.
- 3.192 The analysis set out in this report shows that the target of a deficit value of below 3 per cent within 5 to 10 years can be achieved without any assumptions in increased growth. Achieving the growth aspirations set out in Part A would have the effect of bringing forward the timescales required to meet the fiscal target.
- 3.193 A potential transitional fiscal boost to growth should be considered and should be consulted on, depending on the prevailing economic circumstances and the perspectives and price required by debt providers.

Main Recommendations – Part B

- 3.194 As with Part A we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control. Where greater policy responsibilities are required (such as in migration or taxation) the UK Government should be approached and co-operation sought for policies that would benefit Scotland's performance long-term.
31. **Annual Solidarity Payment:** Following a successful independence vote an Annual Solidarity Payment should be created to allow the Scottish Government to pay an agreed share of the servicing of a net balance of UK debt and assets and any continued shared services payments.
32. **Comprehensive Review of Inherited UK Spending Programmes:** reporting within two years this would analyse the inherited strategy and choices for spending across the UK programmes excluding defence which would be subject to separate consideration. The purpose would be to identify savings from costs that need not be replicated, and tailoring to Scotland's specific position and needs. A saving of £1 billion should be targeted. As government functions are transitioned, further savings should be targeted by replacing the UK approach with institutions modelled on the best of the small advanced economies e.g. in tax collection. This element should target a saving of 0.3% of GDP by year 5.
33. **Standing Council on Scottish Public Sector Financial Performance:** this should be established to institutionalise the high performance and best practice (compared

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

34. **Fund for Future Generations:** this fund should be created from all windfall revenues including any from North Sea oil and gas. The focus of the fund would be on risk bearing by the public sector in exploiting inter-generational opportunities in the areas of Inclusive Growth, the Green Economy and cutting-edge innovation projects. Further work is required on the detail of its remit and governance.
35. **Fiscal Targets:** should be established and adhered to:
 - i) Public debt should be maintained at no more than 50 per cent of GDP with borrowing only for public investment in net terms over the course of the cycle.
 - ii) Public sector deficit should be reduced to below 3 per cent of GDP and maintained at levels consistent with a 50 per cent debt threshold. Over time the definition of fiscal balance should be extended to a broader balance sheet perspective to ensure no 'off-balance sheet' practice diminishes transparency.
36. **Scottish Fiscal Commission:** the resourcing and remit should be extended as policy competences are increased over time. Consideration should be given to its ability to measure the distributional impact of financial measures as well as the broader macro-economic and fiscal implications.
37. **Budgetary Process Review and Implementation:** the Finance Ministry should lead a budget process to ensure the fiscal transition is delivered effectively. The government's strategic priorities should determine negotiations with spending departments along with high quality spending proposals and a rigorous ongoing review of them. Such a review and implementation should borrow from the best international examples and be implemented as an immediate priority and dovetail with the Standing Council on Scottish Public Sector Financial Performance. The outcome should be a systemic process of structured spending reviews as in countries such as Denmark.
38. **Comprehensive Taxation Review:** is recommended drawing on the best expertise and experience globally with a view to recommending reforms to improve simplicity, neutrality and flexibility. This review should also target a reduction in the inherited UK 'Tax Gap', the difference between actual and anticipated revenues. Given the nature of such a review should be designed to outlast any one Parliamentary term it would be beneficial if a cross-partisan approach could be achieved.

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

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

- 3.195 Part C of the report considers the question of the currency that Scotland should use and the approach to monetary policy and financial regulation in the event of a successful referendum on independence.
- 3.196 In weighing up the options the Commission was able to draw on the wealth of work undertaken in advance of the 2014 referendum as well as the experience and debate through that referendum. This part sets out our view on the best way forward.
- 3.197 In coming to our view, we have listened carefully to all sides of the debate. We have weighed up the reality of autonomy and the effectiveness of monetary policy as a tool of economic growth policy for all countries. We have considered this reality against the transitional implications for the real economy given the nature of the Scottish economy and its close integration, financially, with the rest of the UK.
- 3.198 Scotland would start any independence transition from a position of greater financial and economic integration with the rest of the UK than any other country in recent decades who has made an independence choice. Similarly, the financial services sector, in all its forms, is of greater importance to the Scottish economy than any other country that has made such a transition in post-war history.
- 3.199 Our approach is therefore to prioritise as far as possible, the removal of any uncertainty around the detailed process of transition for individuals, companies, investors and the wider economy.
- 3.200 It is our view that the role of Monetary Policy and Regulation Policy should be to provide continuity and stability throughout the period of transition and beyond. It is possible that in due course a different approach may have merit depending on the performance of the economy. It is only once the public finances have reached their fully sustainable position and the full institutions of government transitioned and set up that any alternative approach should be considered or 'earned'
- 3.201 Our framework of transition suggests a minimum period of two years from any successful independence vote and the starting point of independent policy. We then anticipate a period of between five and ten years to put the public finances on a sustainable footing.
- 3.202 Substance matters a great deal more than symbols. There will be much work to be done to bridge the gap between Scotland's performance and potential. The prize will be a far better economic performance and living standards and a society modelled on the long-term

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

Currency Recommendation

- 3.203 The Commission recommends that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period.
- 3.204 A future Scottish Government should put in place the arrangements and financial infrastructure that would support a move to an independent Scottish currency at such time as this was considered appropriate for the Scottish economy.
- 3.205 What happens with respect to currency the day before an independence vote would happen the day after and continue to happen until such time as the elected Scottish Government seeks to do something differently.
- 3.206 The Commission recommends that a decision to move to an independent Scottish currency should be based on a governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is a necessity to maximise certainty and stability, and to minimise risks. We recognise that this means that the Scottish Government would not secure monetary policy sovereignty in the initial period following an independence vote though the Scottish Government would not be in a formal monetary union.
- 3.207 This option allows the focus of the government, individuals, investors and businesses to be on policy choices for growth and the sustainability of public finances and the development of necessary institutions. It also removes a range of uncertainties concerning existing arrangements and contracts.
- 3.208 We note that this was the approach taken by Ireland for an extended period, albeit in a different period of history.
- 3.209 The existing financial assets and liabilities of Scottish residents, and the financial assets and liabilities which residents of countries outside Scotland hold with Scottish institutions, are assets and liabilities of these individuals, businesses and institutions, not assets or liabilities of the Scottish Government, before or after independence.

Future options: governance & tests

- 3.210 The arrangements supporting the Scottish currency and the Scottish financial system should allow for the possibility that the Scottish Government may choose to establish a separate currency at some future date.
- 3.211 In order to secure maximum long-term certainty, we recommend that the governance and rules by which any future choice could be taken be set in advance.
- 3.212 The introduction of a separate Scottish currency, would be subject to six tests, an assessment of which would be made by the Scottish Government and put to the Scottish Parliament for approval:
1. **Fiscal sustainability:** Has the Scottish Government sustainably secured its fiscal policy objectives and sufficiently strong and credible fiscal position, in relation to budget deficit and overall debt level?
 2. **Central Bank credibility and stability of debt issuance:** Has the Scottish Central Bank and Government framework established sufficient international and market credibility evidenced by the price and the stability of the price of its debt issuance?
 3. **Financial requirements of Scottish residents and businesses:** Would a separate currency meet the on-going needs of Scottish residents and businesses for stability and continuity of their financial arrangements and command wide support?
 4. **Sufficiency of foreign exchange and financial reserves:** Does Scotland have sufficient reserves to allow currency management?
 5. **Fit to trade and investment patterns:** Would the new arrangement better reflect Scotland's new and developing trading or investment patterns?
 6. **Correlation of economic and trade cycle:** Is the economic cycle in Scotland significantly out of phase with that of the rest of the UK, or at least as well correlated with the cycles of other trading and investment partners, thus making an independent monetary policy feasible and desirable?
- 3.213 The conditions and rules that would determine a change of monetary policy and currency choice should, as articulated in this chapter, be made very clear in advance. In the event of a new Scottish currency being created it is likely that a period of 1:1 pegging with sterling would make sense for the short and possibly medium term.

Scottish Central Bank and Scottish Financial Authority

- 3.214 The Commission recommends that two new institutions are set up, the Scottish Central Bank (SCB) and a Scottish Financial Authority (SFA), which would be an independent wholly owned subsidiary of the Scottish Central Bank.
- 3.215 These new institutions should be created to provide the governance, necessary functions, structures and approaches of the existing UK institutions. The resourcing, scale and less complex nature of Scottish institutions would reflect the simpler structure and the different composition of the Scottish financial system.
- 3.216 The Scottish Central Bank would assume final responsibility for the functions, in Scotland, of the FCA and the PRA in the UK through its SFA subsidiary (including both banking and insurance supervision).
- 3.217 It would act as banker to the Scottish Government, and hold deposits and provide liquidity support, subject to the asset and collateral requirements, for Scottish retail banks, to the extent necessary to protect retail depositors. The SCB would operate a clearing system for these banks. It would also establish a Scottish Financial Services Compensation Scheme similar to the UK FSCS.
- 3.218 As a result, there is no reason why Scottish businesses and individuals should expect to borrow on terms in any way different from their rest of UK counterparts.
- 3.219 Banks operating in Scotland with Scottish headquarters or through Scottish subsidiaries (and hence regulated by the SCB) would be required to ring-fence their retail banking operations along the same lines as now proposed for the UK. The SCB would put in place a resolution regime similar to that in the UK for the orderly winding down of failed banks. Financial support from the SCB would not extend to the holding companies of retail banks to cover activities outside Scotland, or beyond what is needed to ensure that retail depositors in Scottish banks are protected. It is anticipated that a number of banks may re-domicile their registered headquarters to London. A substantial part of the executive functions of these banks is already in London and so there would be a very limited impact on operational activity.
- 3.220 The supervisory culture and institutional structures in Scotland will remain closely aligned with the arrangements for the rest of the UK and Scotland should aim to become a natural bridge between the rest of the UK and the EU.
- 3.221 The SFA will focus on all other parts of the financial sector in Scotland.

- 3.222 It is anticipated that it would operate a unitary regulatory model combining prudential and conduct regulation.
- 3.223 The transition arrangement should seek to 'grandfather' as much as possible from the UK arrangements.

Main Recommendations – Part C

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

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

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

- i) Fiscal sustainability
- ii) Central bank credibility and stability of debt issuance
- iii) Financial requirements of Scottish residents and businesses
- iv) Sufficiency of foreign exchange and financial reserves
- v) Fit to trade and investment patterns
- vi) Correlation of economic and trade cycle

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

47. **Scottish Financial Authority:** as an independent wholly owned subsidiary of the Scottish Central Bank. Adopting the responsibilities of the UK FCA and PRA it would also take the lead on other (non-banking) parts of the financial sector in Scotland.
48. **Scottish Financial Services Compensation Scheme:** should be established by the SCB mirroring the UK FSCS scheme.
49. **Bank regulation:** banks regulated for their activities in Scotland by the SCB/SFA would be required to ring-fence their retail/commercial and mainstream corporate banking operations. A resolution regime would be established mirroring the UK approach for the orderly winding down of failed banks. The transition arrangements would 'grandfather' as much as possible from the UK arrangements.
50. **Lender of Last Resort:** the SCB will act as lender of last resort to individual banks with a liquidity rather than solvency problem and provide emergency liquidity assistance to the banking system where there is a systemic need. After consultation, the SCB would introduce rules on capital structure and asset quality on retail banks to ensure that adequate collateral is available to match retail deposits in such banks. Financial support should only be provided to the ring-fenced retail entities operating in Scotland. It should not extend to the holding companies of retail banks whether operating in Scotland or elsewhere.

4 CONCLUSIONS AND NEXT STEPS

- 4.1 This report is now passed to the First Minister for the consideration of her party and Government as it determines the course of its economic policy approach for the short, medium and long term. It is also offered to all sides in the political and economic debate in Scotland (and indeed further afield) in the hope that it represents a considered and elevating contribution to the debate.
- 4.2 The Commission does not suggest that any part of the report represents the 'last word' on any of the topics we have examined. What we earnestly hope, however, is that it creates a framework and level of content that allows the level of debate to mature considerably. While we are perfectly aware of the likely responses of many critics to the immediate publication in what is often both a fierce and shallow political discourse, we do anticipate that its value will come longer term as all sides consider carefully the best interests of the country in what is a remarkable era of tumult in the global system.
- 4.3 We also recognise that some of the analysis and conclusions of this report represents a challenge to established thinking. We do not expect universal support from within the party or indeed from anywhere. However, we would not have been doing our job and addressing the remit we were given without being prepared to adopt such an approach.
- 4.4 Inevitably, much of what we recommend involves further work, analysis and consideration. We encourage a purposeful approach to commencing that as soon as is practicable.
- 4.5 If the electorate of Scotland is asked to choose again on the question of independence, this report should mean that it will do so with more information, understanding and certainty than that previously offered on any choice of such magnitude. In the meantime, this work should enhance understanding and debate in a way that we hope can raise the quality of policy ambition across the political spectrum.