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Debt and Destiny

An assessment of an independent Scotland's fair share of the United Kingdom's national debt and the impact it could have on Scotland's future.

by Jonathan Price

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About the Scotland Institute

The Scotland Institute is a progressive and independent think tank set up to deal with the changing face of Scotland. It aims to investigate the implications of devolution while finding innovative solutions to the old problems of social exclusion, and to encourage Scotland's competitiveness in the global market. Through high-quality comprehensive research and policy making it hopes to put Scotland on a path towards a more competitive, progressive, and optimistic future.

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Jonathan works for Inter Mediate, a London based conflict resolution NGO whose aim is to ensure that meaningful dialogue is initiated wherever the appropriate fora for dialogue are non-existent or ineffective.

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Chairman's Statement

Ever since the dark days of the Financial Crisis of 2008/2009 and subsequent economic troubles, one issue above all has dominated the political landscape: the issue of debt. Public debt, the debts owed by the government, has been the challenge that has been gluing together the current UK coalition government between the Conservatives and the Liberal Democrats, and the issue on which the government has enjoyed the highest level of public support.

Now, however, the issue that will dominate the news cycle over the next few months will be the referendum on Scottish Independence in September. Yet, the odd thing is that these two debates have had very little to do with each other so far. Just as we have accepted the seriousness of the issue of debt, we seem to have been largely oblivious to its implications for the Scottish question. A future, independent Scotland's fair share of the UK debt absolutely has to be one of the top considerations in the referendum debate, and it is time that the public got well acquainted with the facts and the likely outcomes of this issue.

This report aims to address this lack of information. We recognise that there are many topics that will excite the attention of the newspapers: one such topic is whether Scotland will get to keep the Pound Sterling. But in fact, many economists believe that the issue of debt will be much more important than that of a currency union. How the debt rightfully accruing to Scotland will be calculated and administered may have far deeper consequences for the average Scot than whether they have Scottish Pounds or Pounds Sterling in their wallet.

That is why we have spoken to dozens of top economist, experts, policy makers and also top credit rating agencies. These issues are so important and sensitive, that some of them have asked us to not name them.

Here, in brief, is what we have found.

First of all, it is certain that Scotland wants to take on its fair and equitable share of the debt. It is highly advisable that it does so, because this will be the first test of credibility of an independent Scottish state in the eyes of the international community. And this will be the only course of action that will set Scotland on a secure path to future prosperity as a full and respectable member of the international community. And despite some political posturing, the SNP government in Edinburgh is also effectively committed to this.

The debts are likely to be divided between an independent Scotland and the rest of the UK as follows:

- Existing debts that can be geographically linked to either country will be allocated to that country.
- Existing non-identifiable debts will be divided by population share. This means that Scotland will get approximately 8% of these.
- Future liabilities (e.g. pensions commitments) will be negotiated against other issues of contention around the separation such as: the division of oil and gas assets in the North Sea, the currency union, diplomatic arrangements, Trident, etc.

The upshot is that Scotland is likely to end up with a slightly lower debt burden per capita than the rest of the UK, but this will still total over 86% of GDP. The downside is that Scotland is likely to end up with a much lower credit rating (between BBB- and A), and significantly higher borrowing costs than it currently enjoys within the Union, with interest on government bonds likely to be at least 1% higher.

In all cases, it will be in Scotland's best interest to negotiate a clear and agreeable solution as quickly as possible, which weakens its negotiating position. It is quite likely that the debt burden it will end up taking on will be higher than it would have liked.

Our main conclusion is that in light of all this, and of the economic structure and fiscal profile of a future independent Scotland, any future Scottish government will very likely to be forced to carry out significant fiscal consolidations. This means that a future Scottish government's policy options on spending are likely to end up being more limited than they are even now, and Scottish voters should be wary of SNP promises on certain issues such as greater public spending in the future.

Dr Azeem Ibrahim

Executive Chairman

Preface

This report aims at providing an accessible and independent assessment of the likely division of national debt between an independent Scotland and the United Kingdom should Scotland vote for independence on 18th September 2014, as well as the immediate implications that this would have for any future Scottish government.

The report's conclusions follow an examination of the legal, historical, economic, and political contexts in which any future settlement would be negotiated. The report relies on open source, desk based research, and interviews with leading figures from the academic, legal, think-tank and political worlds.

The report is both backward and forward looking. As such, there are parts of it that are straight-forwardly factual, whereas the future projections are based on a blend of historical evidence, discussions with officials and decision makers, and wider observations. Throughout the report, every effort has been made to be clear as to where the distinction between the factual and the speculative lies.

Of course, it is the projections that will be disputed. But the merit of this report lies in the extent to which it accurately speaks to today's circumstances and seeks to answer tomorrow's questions. As with any speculation on the future, the only thing that is certain is the uncertainty of what will happen. What we can do in our situation, however, and what is crucially important here is that this report seeks to assess future prospects in an independent and neutral manner, in an effort to provide any interested Scot with a non-biased assessment of debt allocation and the implications this could have on his or her daily life.

Contributors

The Scotland Institute would like to acknowledge and thank all those who generously shared their knowledge and insights for this report. In particular, we would like to thank:

- Paul Johnson – Director, Institute for Fiscal Studies
- Tony Dolphin – Senior Economist and Associate Director for Economic Policy, Institute for Public Policy Research
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- Robert Rowthorn –Emeritus Professor, Facility of Economics at University of Cambridge
- Ana Stanic, Solicitor Advocate, E&A Law
- The Lord O'Donnell GCB – Former Cabinet Secretary and Head of the Civil Service
- Rt. Hon. Alistair Darling MP – Leader of the Better Together Campaign and former Chancellor of the Exchequer
- Iain Gray MSP – Shadow Cabinet Secretary for Finance
- Gavin Brown MSP – Scottish Conservative Party Spokesperson on Finance
- Rt Hon. the Lord Hope of Craighead KT – former Deputy President of the Supreme Court of the United Kingdom
- Willie Rennie MSP – Leader of the Scottish Liberal Democrats
- Jonathan Powell – Former Chief of Staff to Tony Blair

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Finally we would like to thank those who also kindly met to discuss the report but asked to remain anonymous.

Executive Summary

Should Scotland vote for independence on 18th September, representatives of Scotland and the remaining UK would need to negotiate a final settlement to end the 300-year long union. Amongst the key matters that would need to be agreed by the parties would be how to divide their shared debt. This report provides a survey of the legal and historical context of any future debt allocation negotiation, before outlining potential challenges, and suggesting the likely contours and outcomes of the debt burden allocation. Finally the report considers the likely implications that the division of debt would have on an independent Scotland and its government's ability to implement policy.

In summary, the report concludes that an independent Scotland would agree to reimburse the remaining UK for a "fair and proportionate" share of the entire debt calculated by applying a combination of different methods of division to different types of debt. Whilst Scotland would most likely come away with a smaller debt to gross national product ratio than the remaining UK, its debt will still be very high. This level of debt, when taken together with other factors (institutional and governance effectiveness, economic structure and growth prospects, external liquidity, fiscal performance and flexibility, and monetary flexibility), would very likely result in an independent Scotland receiving a lower sovereign credit rating, and thus incurring higher borrowing costs. In light of this, any future independent Scottish government would need to further consolidate its fiscal position, meaning either an increase in taxes, a reduction in government spending or a combination of these two measures.

That conclusion is derived from the following central findings:

- **Domestic and international law** does not provide binding rules for the allocation of debts in cases of state succession. International law does however confirm that debts are not extinguished by succession, that division is decided by the agreement of the parties involved, and that any allocation ought to be equitable, taking into account the division of assets.
- **Historical comparative experience** shows that there is no standard and internationally used method of division, that a combination of methods and tools tend to be applied to different forms of debt and that equity plays a significant role in calculating any apportionment, taking into account the division of assets as well as expediency and relevance.
- **The particularities of Scotland and the UK** indicate that Scotland would accept a share of debt, as failure to do so would significantly weaken its financial profile in the markets; and that owing both to practical economic

and political self interest reasons, the parties are likely to divide existing identifiable debts to their respective identifiable country, while non-identifiable debts would most likely be divided on a population basis. Any significant compromises on debt by either side would most probably relate to future identifiable and non-identifiable debts arising from current obligations (e.g. oil and gas platform decommission costs) and would be impacted by wider negotiation issues. As such, the report expects that these future liabilities would not be divided according to any standardized measure.

- **An independent Scotland's high debt burden,** whilst smaller than that of the UK, and by itself not necessarily alarming, would be exaggerated by other factors significant for determining Scotland's financial profile to international lenders. Crucial to this are its changing demographics, exposure to the volatile gas and oil market, significantly large gross external financing, limited expected liquidity, and anticipated fiscal performance. If an independent Scotland does not enter a monetary union with the remaining UK, it would likely incur an even lower credit rating and higher borrowing costs in the short to medium term.

The report assumes and expects that the any future negotiations would be entered into in the spirit of cooperation set out in the Edinburgh Agreement and see both states "work together constructively…in the best interests of the people of Scotland and of the rest of the UK."

1. Introduction and debate to date

Debt matters. Amongst the many reasons for this is that a country's debt burden impacts on its credit worthiness and so its capacity to, and cost of, financing public spending through borrowing. And the level of a country's indebtedness has been made even more important following the recent financial crisis, which saw even the more advanced economies come under close scrutiny by nervous creditors.

In the event of independence, the level of debt an independent Scotland would begin with has the capacity to have a very real and felt impact on the Scottish people. If the debt level would be significantly lower than it is at present as part of the United Kingdom, Scots would expect any future independent Scottish government to have an increased capacity to make and implement policies. Of course, the reverse is true if the debt level would be greater. Despite the importance of this matter, so far it has been treated as either a sub-category of wider discussions (e.g. currency union), or as a marginal issue, not fully taking into account the legal, historical or political context in which debt allocation/management would be made.

Politically, there is general agreement that in the event of Scottish independence, the newly formed Scottish state would accept liability for a portion of the United Kingdom's debt and that this would be decided through a negotiated settlement. Alex Salmond, Nicola Sturgeon and John Swinney have all confirmed this on separate occasions, as has the Scottish government' *Scotland's Future* and most recently in its *Outlook for Scotland's Public Finances and the Opportunities of Independence*. Importantly, Alex Salmond and the Scottish government have always linked the acceptance of debt liability with a share of the UK's assets (which collectively they extend to include the sterling currency and the Bank of England as lender of last resort). Alex Salmond, Nicola Sturgeon, and John Swinney have repeatedly said that if the United Kingdom refused Scotland a fair share of the common assets (including sterling currency union), then Scotland would refuse to accept the common debt liability, citing international law in support. This has led some to say that any such refusal to accept liability for UK debt would have negative consequences for Scotland. Danny Alexander has warned that this would be damaging to Scotland's financial credibility, lowering its credit rating and increasing its cost of borrowing, a view shared by Lord O'Donnell, amongst others. Alistair Darling has said that this would be viewed as a default – something that Alex Salmond flatly rejects on the basis that Scotland, as a newly created, successor state, would never have had the debt in the first instance.

The UK government has made it clear that it would expect an independent Scotland to take a fair share of the debt liability. However, it has chosen to reject the Scottish governments' view that the sterling currency, as a means of exchange,

is an asset, and furthermore, on the advice of Treasury officials, has said that it would not enter into a formal currency union with Scotland should it decide to become independent.

The outstanding two key questions are what level of debt would Scotland accept and how would this be administered? The Scottish government's *Scotland's Future* outlines two possible measures for dividing the debt liability: on the basis of per capita share and on a historical contribution basis. These two measures are also outlined in The Scottish Government's Fiscal Commission Working Group's First Report – Macroeconomic Framework. Elsewhere, Alex Salmond has commented on the possible division based on a Gross Domestic Product (GDP) share but seemed to indicate that a division on a per capita share would be more likely. Most recently, the Scottish government's *Outlook for Scotland's Public Finances and the Opportunities of Independence,* introduced a third option – zero share of UK debt. This is described as "only likely in the event that Scotland did not receive an equitable share of UK public assets". In that report, the Scottish government stated that it expected any final debt settlement to result in a debt allocation with a figure between per capita share and zero.

The UK government has not explicitly suggested its preferred measure(s) for debt liability division, as its policy is not to pre-negotiate in advance of the referendum. However, the House of Lords Select Committee on Economic Affairs in *The Economic Implications for the United Kingdom of Scottish Independence*, recommended that the "existing UK public sector debt should be apportioned… by share of population". Most recently, and tellingly perhaps, HM Treasury's *Scotland's analysis: Fiscal policy and sustainability* projected Scotland's future debt burden using a per capita method of division, indicating that this is the UK government's current view on the matter. Although this does leave open the possibility of division by gross national product.

The prospective arrangement for the administration of the debt has been in part clarified by Danny Alexander's statement to the market *UK debt and the Scotland independence referendum* published January 2014. In this, the United Kingdom government made it clear that in the event of Scotland becoming independent, the existing debt would remain that of the UK (and not be transferred to Scotland) but that an entirely separate agreement between the remaining UK government and a new Scottish government would be established in which the latter would repay the former a "fair and proportionate" share of the debt. This is consistent with options outlined by the Scottish Government's Fiscal Commission Working Group and *Scotland's Future*, and so there is no reason to believe that this would not be the arrangement. What remains less certain, and to which no conclusive answer has yet been given by either government, is the terms that would be included (e.g.

would full repayment by expected on independence or would a payment schedule be agreed), the conditions of administrating this separate agreement, and the financial implications this would have for an independent Scotland.

Technical assessments of debt division have been made. The National Institute of Economic and Society Research has published widely on the economics of independence. Most recently the Institute outlined in *Scottish Independence and the UK's Debt Burden*, different measures of debt valuation, and applied a per capita division of debt, citing the dissolution of Czechoslovakia as precedent. In *Scotland: Currency Options and Public Debt*, they similarly applied a per capita division of debt. The Institute for Fiscal Studies operated on the basis of a per capita division of debt in its assessment of Scotland's fiscal sustainability. These, and other technical and economic assessments by think tanks and financial services, whilst useful, recognize that the division itself will be the result of negotiations. In particular, they do not attempt to analyse the legal, historical and political setting. Rather, they outline different debt burden scenarios based on different methods of debt division.

Surprisingly, there has been little attempt to understand the existing legal basis for debt allocation. The Scottish government has repeatedly said that if the UK remains the continuing state, Scotland would not be legally liable for any of the debt, quoting two experts in *Division of UK Public Sector Debt- Implications for Scotland and the Rest of the UK*. A number of academics have however commented on this such as, for example, Dr Qvortrup from Cranfield University in *New Development: Comparative perspectives on political divorce settlement – what happens when a country secede?* He concluded that since the United Kingdom would be legally considered a continuing state and Scotland a successor state, then Scotland would not inherit any debt.

Debt matters, and this has in part been reflected by the increasing discussion of it in the Scottish independence debate, especially since the start of 2014. Nevertheless, the debt question continues to be answered within either an excessively wide framework (mainly owing to the Scottish government's insistence of viewing it in terms of a sterling currency union) and/or as a marginal issue and in isolation from the various aspects (legal, historic, economic, political) that will influence any future negotiations should Scotland vote for independence. This report aims to provide a focused discussion of debt division and to "join up" the various aspects that would make up part of a negotiated settlement of debt in the event of a vote in favour of independence. Based on this, an assessment is made on the implications that the division of debt would have on future Scottish governments.

2. Legal Context

National debt is debt assumed by a state's government. Given that this is set within a legal framework of contractual rights and obligations between the creditor/lender and the state, it is useful to establish in the first instance what legal provisions and/or mechanisms exist for managing debt in the case of state succession. It is important to consider this from both a domestic and international legal perspective.

a. Domestic Law

There is no legal provision for debt allocation in the case of state succession in UK domestic law. The United Kingdom of Great Britain was formed on 1st May 1707 following the approval of the Treaty of Union by the passing of the Acts of Union by both the Scottish and English parliaments. These Acts in part govern the terms and conditions of the union. No provisions were made for separation – economic or otherwise. No other existing statute provides for debt allocation should the union dissolve.

The succession of Ireland from the UK could potentially be considered a legal precedent. When Ireland seceded from the UK, the Anglo-Irish Treaty in article five provided that the Irish Free State would assume liability for a "fair and equitable" proportion of public debt and war pensions. Following negotiations, the parties agreed to annual payment of £5 million per year. However, owing to wider economic (Ireland was impoverished and paying heavy costs from the Irish Civil war of 1922-23) and political (Boundary Agreement of 1925) developments in 1920s, Ireland was released from its obligation in the Ireland (Confirmation of Agreement) Act 1925. As the Law Society of Scotland made clear in their written evidence to the House of Lords Select Committee on the Constitution, the "circumstances are significantly different" in the British/Irish arrangement from a potential Scotland/UK applicability. Nevertheless, this could be considered a potentially non-binding precedent.

b. International Law

Likewise, there is no enforceable international treaty or agreement on the division of national debt in the case of state succession. Neither is there an enforceable customary law or a universal acceptance of any particular theory regarding state succession and obligations. As such, no international legal rules exist for

governing debt allocation. Nevertheless, practice points to the emergence of legal principles reflected in *The Vienna Convention on Succession of States in Respect of State Property, Archives and Debt 1983* (*Vienna Convention*) which aimed at codifying the growing body of state practice following decolonisation. Whilst neither authoritative nor enforceable, they are still instructive in outlining three basic principles regarding national debt in cases of succession. These are that: the repayment should be honoured, the division by the parties should be made by agreement, and where this is not the case, national debt will pass to the successor state "in equitable proportion", taking into account also the division of assets. This indicates that the debt continues to be enforceable, that national debt does transfer to successor states, that the allocation is by agreement rather than by a set formula, and finally that some principle of equity should apply.

Underlying the first of the legal principles is a policy-oriented approach that seeks to maintain international order, uphold the sanctity of contracts, and protect international trade and capital markets. As such it confirms that contractual and treaty obligations continue to exist following state succession and rejects claims that in cases of state succession, newly created states are not in some way bound by historical obligations. Historical precedent supports the continuity of contractual obligations entered into by predecessor states following succession both in relation to public debts (in every succession in Europe since 1991, successor states have honoured existing debts) and private, commercial debts (e.g. *Russian Federation v. Pied-Rich B.V.* where the Dutch Court of Appeal held Russia, as the continuing state of the USSR, was bound by the existing obligations of the USSR with Pied-Rich.)

The question becomes whether these debts are automatically transferred to the successor states (universal succession) or transferred with the subsequent agreement of the successor state only (clean-slate). Russia claimed to be automatically liable for the USSR's debts, supporting the automatic succession approach. However, following East Timor's succession from Indonesia, the existing commercial treaty between Indonesia and Australia regarding rights to proceeds from resources extracted from the Timor Gap did not automatically transfer, but were renegotiated and only accepted by the newly created state once the terms were more equitable. The dissolutions of Czechoslovakia and the Socialist Federal Republic of Yugoslavia can be used to support either case, as can the case of Hong Kong's reversion to China. The law remains ambiguous in this regard and open to interpretation. What is clear from all these examples is that the succession negotiations themselves play a crucial role in developing the narrative as to whether the debts automatically transfer or are entered into by

subsequent agreement by the successor state, and that this is more a political than legal decision.

Overall, recent state practice seems to support the view that where one party to state succession is deemed to be a continuing state, then the debts automatically transfer to it. While the *Vienna Convention* makes no significant differentiation between whether or not the predecessor state continues to exist after the succession or separation either for the division of debt or the manner in which is done, earlier and subsequent state practice does. The significance of this lies in the growing evidence supporting the legal presumption that where the predecessor state continues to exist following a secession or separation, then the continuing state maintains the entirety of the national debt. Importantly, and according to this view, the continuing state receives the entire state assets as well as the debts. Under this presumption, no debt is transferred to the newly declared, independent state, although a separate agreement may be entered into for a reimbursement of a share of the debt in exchange for state assets. The justification for this approach is simple. If the state is held to be a continuation, then the parties to the original contract or treaty giving rise to the liability remain and so must the agreement.

This is a confusing area of the law as historical precedents provide a mixed view. In the cases of Texas seceding from Mexico (1840), Panama from Colombia in (1903), Pakistan from India (1947), the continuing state remained entirely responsible for the national debt, although separate agreements for repayment were made in some instances. However, other cases suggest that a measure of the debt is transferred to the new state/s. Historical examples such as the successor states of the Austro-Hungarian Empire, the Ottoman Empire and the Irish Free State from the United Kingdom are often cited in support – although in the latter case, the debt was subsequently erased. However, recent examples such as Russia and the Federal Republic of Yugoslavia support the presumption that continuing states do remain liable for the entirety of the debt.

In the case of Russia, it successfully negotiated the acceptance of the USSR's entire debt with its successor states and creditors through a series of individual zero-option agreements in order to build its case to the international community that it was a continuing state (and so secure its position in international organisations such as the U.N.) and to secure Soviet assets. The international community both encouraged this and acknowledged its final outcome (i.e. Russia assumption of the entire debt), therefore strengthening the view that continuing states inherit the entire debt burden. In the case of the Federal Republic of Yugoslavia, whilst it did not ultimately succeed in being recognised as the continuing state of the Socialist Federal Republic of Yugoslavia (SFRY), it attempted to do so in part through its

acceptance of debt. As such, following its declaration as a continuing state in April 1992 it continued to repay SFRY's debts to the IMF until September 1992 to strengthen its claim to continuity. Finally, the most recent case of state succession involving a continuing state is Sudan. In this case, Sudan has retained all debt, with South Sudan not receiving any liability from previous obligations. However, the discussions surrounding liability for historically accumulated debt have not been concluded, and depend largely on a debt relief arrangement being entered between Sudan and its creditors.

To varying degrees, these cases indicate that contrary to article 40 of the *Vienna Convention*, successor states do not receive a portion of the debt where a party to the succession is considered to be a continuing state. This is consistent with the legal principle of the sanctity of contracts. Nevertheless, state practice in the case of Russia shows us that in such an instance, although the debt is not apportioned and transferred, separate agreements between the continuing state and the successor state(s) are often reached which seek to compensate the continuing state for its liability and the successor state for its loss of assets.

The UK government, having sought legal advice and published the *Scotland analysis: Devolution and the implications of Scottish independence*, takes the view that the UK would be a continuing state. As such, and in accordance with the non-binding legal presumption derived from recent state practice, the remaining UK would retain all of the existing national debt. The recent publication of *UK Debt and the Scotland independence referendum* by HM Treasury, confirms that this is the UK government's understanding, and that it would seek to enter a separate agreement with an independent Scotland to secure a reimbursement for a proportionate share of the debt. The Scottish government in response to this published *Division of UK Public Sector Debt –Implications for Scotland and the Rest of the UK.* In this, the Scottish government noted Professor Christine Bell and Professor David Scheffer's support of the view that if the UK is considered a continuing state then it would keep all the liabilities for the debt, and Scotland would be released from the any debt repayment obligations. Significantly, however, and following this logic to its conclusion, it must also infer that firstly, the remaining UK would have a continuing claim over state assets, and secondly, it that it would need an independent Scotland to agree to such an arrangement. This raises a number of non-legal challenges and opportunities for both the remaining UK and independent Scotland, which the report explores in section five below.

In summary, neither domestic nor international law provides concrete rules for the division of debts should Scotland vote for independence. Domestic law has no provisions for the break up of the union, while international law is lacking in either

an enforceable treaty or authoritative customary law. Nevertheless, evolving state practice demonstrates that debts are not extinguished by succession, that division is by agreement between the parties, including the creditors, and that any division must consider fairness as part of its calculus. Furthermore, recent examples including Russia and FRY support the view, but by no means definitely conclude, that in cases where one party to the succession is recognised as a continuing state, then it as a continuing state inherits the entire historical debt (along with its assets). This is contrary to the *Vienna Convention* where debts (and assets) are divided between the parties in all cases of succession. Thus whilst neither domestic nor international law offer definitive or binding legal rules, they nevertheless provide a series of principles, and possible trends, which will frame any future negotiation leading to settlement between Scotland and the United Kingdom.

3. Historical comparative analysis

It is clear that any debt allocation between the remaining UK and an independent Scotland would be based on the outcomes of negotiations in light of the absence of any governing legal rules or mechanisms. Various methods could be used for calculating debt apportionment, all of which produce different results. In the debate so far, two methods have been repeatedly mentioned: division by population share or division by historical contributions. Other methods could be considered also, including division by gross national product, by geographical location, or by an agreed formula. Given that the legal context does not provide an answer to this, the following provides a summary of how the debt question has been answered in other, historical succession cases, outlining the different methods of division considered and used. In doing so, it aims to situate the potential methods of division on which the Scottish and UK negotiations teams may draw, and highlight any emerging trends or patterns. Given the large number of historical cases that could be drawn upon, particularly following the end of colonisation, the report has chosen to limit its focus to post Cold War, European cases were debt division was considered as part of actual succession. This includes an examination of Russia, Yugoslavia and Czechoslovakia. These three historical examples have been selected as they are closer culturally and economically to the UK than other potential examples in the recent post Cold War era (e.g. Eritrea and Sudan) and therefore bear greatest relevance.

Russia provides an interesting historical comparison. As already mentioned during the discussion of the legal context, Russia ended up being considered the continuing state of the USSR, a legal status achieved in part by adopting its entire debt burden through entering into a series of bi-lateral zero-option agreements with the USSR successor states. Russia as a historical example therefore shows how debt was not allocated to the successor states when one member is held to have continuing status. However, this was a policy-oriented approach to debt division which responded to creditor states concerns and Russia's foreign and domestic interests. Moreover, it is a conclusion which ultimately reversed initial planning for state dissolution and a sharing of state debts and assets. This reversal was encouraged by the international community, who wanted to secure repayments of USSR's debts, estimated at $60bn in 1991. Creditors demonstrated this desire when they insisted that Russia was jointly and severally liable for the debts of the USSR distributed to the successor states, and that the debt would be managed and serviced by the *Vneshekonombank* (USSR central bank). Russia itself wished to inherit the debt in order to strengthen its case as a continuing state (and therefore secure its international treaties) and gain control of former Soviet assets. As

such, during 1992, Russia embarked on a campaign to frustrate successor states attempts to allocate and distribute debts between themselves, whilst at the same time engaged in a series of bilateral zero-option agreements with the successor states whereby, it was agreed that they assume the successors' share of debt in return for a share of the former Soviet Union assets. In doing so, they reversed the division of debts and assets as contained in *The Treaty on Succession with Respect to the State Foreign Debt and Assets of the Soviet Union* agreed to by Russia along with Ukraine, Belarus, Kazakhstan, Armenia, Kyrgyzstan, Tajikistan and Georgia on 4th December 1991. In that treaty, the parties agreed to divide the debts and assets according to a "single aggregative index," which is believed to have been based on demographic and macroeconomic indicators. By the end of 1992, Russia had secured bilateral agreements with all the successor states apart from Ukraine, which was delayed until April 1993. In short, for the purposes of method of division, Russia's example shows:

- firstly, that in cases of dissolution (as originally envisaged) a tool for division could be a formula based on a combination of demographic and macroecomonic factors;
- secondly, that no distinction is necessarily drawn between national and territorial or geographic debt; and
- thirdly, that if there is a continuing state, the continuing state may adopt the entire debt, but that this may have no immediate effect on the other successor state(s), and requires that the continuing state and successor state(s) enter into separate agreements whereby exchanges of debts against assets are made.

Like in Russia, creditors played a significant role in the allocation of debts in Yugoslavia. Unlike with Russia however, no single state was recognised to be a continuation of the Socialist Federal Republic of Yugoslavia (SFRY), no single method of division was applied, and the debt division was long, protracted, and complicated by ongoing violent and political conflict. Importantly, different negotiations were entered, and methods of division applied to the differing debts. These debts totaled $15.99bn at the end of 1991, and were composed of debts to international organisations ($683 million to the IMF and $2.14bn to the World Bank), creditor states (the "Paris Club", which was owed $4.15bn) and commercial banks (the "London Club", which was owed $4.3bn). Regarding the debts owed to international organisations, a single but different method was applied to each one. Obligations to the IMF were apportioned according to what is known as the "IMF Key", which divided the debt using a formula which took into account the successors states historical contributions to the SFRY, product

and export earnings, population and territory. This was accepted by successor states in August 1993. Obligations to the World Bank were apportioned by it to the successor using the final beneficiary rule according to which the territory that benefited from the loan was to repay it. The reason for this was that the debts had been granted to finance projects in specific republics and could therefore be identified with a particular region. As such, regardless of the fact that the SFRY contracted the debt, it was divided according to which republic benefited from the loan and as such the debt was territorially attributed. Debts owed to creditor states, which were mixed between allocated (66%) and unallocated (33%) loans, were divided by the creditor states and the successor states on a bilateral basis outside of the succession negotiations. In these separate agreements, allocated debt was apportioned in accordance with the final beneficiary rule adopted by the World Bank, whilst unallocated debt was divided using the IMF Key. The same approach to debt division was taken by the commercial banks and the successor states, both in terms of the process (bilateral agreements outside of the formal succession negotiations) and the methods of division (the final beneficiary rule applied to allocated debts and the IMF Key to non-allocated). So for the purpose of methods of division, the Yugoslavian example therefore shows that:

- firstly, different negotiations may be used to respond to different debts, and that not all debt division may necessarily happen within the context of formal succession talks between the parties;
- secondly, that a distinction between territorial and non-territorial debts can be drawn;
- thirdly, that a variety of methods of division may be used rather than adopting a single method such as the population share; and
- fourthly, that the creation of a key or formula may be a helpful tool for dividing debts in an equitable way.

Czechoslovakia provides a useful comparison given that its breakup was consensual and involved two primary negotiating parties (as would be the case for Scotland and the UK), whereas Russia and Yugoslavia involved multiple successor states. Czechoslovakia officially dissolved on 31 December 1992 following a year of negotiations. Over that period, the Czech and Slovaks Republics concluded over twenty-five inter-governmental treaties in preparation for a managed transition. The parties came to an agreement on succession to debts and assets through their adoption of the *Constitution Law on Division of Czechoslovakia Property Between the Czech Republic and the Slovak Republic* ("Constitutional Law"), on 13 November 1992. This contained provisions for the division of both assets and debts, which like our two first examples, where clearly linked. In this, the parties

agreed that debts (and assets) would be divided on the basis of two methods: territory and population. As such, debts that could be identified as belonging to the territory of either Czech or Slovak republics were in the first instance allocated to them. Debts were held to be identifiable with a region if they were contracted to fund projects in the specific region or if the debt belonged to an institution located in the region. All other debts were allocated by a simple population share, resulting in a two-to-one division. The allocation of debts and assets using this two-method approach was tempered by the principles of efficiency and relevance to ensure an efficient and equitable process. As Harris and Williams in *State Succession to Debts and Assets,* summarise, efficiency "provided that the economic efficiency and further proper use of the property should be safeguarded, while providing for an equitable property and financial settlement" and relevance "provided that rights and obligations that by virtue of their contents applied only to the Czech Republic or Slovak Republic would be transferred only to that successor state." So for the purposes of a method of division, the Czechoslovakian example therefore shows:

- firstly, that multiple methods can be used according to the nature or content of the debt;
- secondly, that a distinction can be drawn between territorial and non territorial debts;
- thirdly that a division by population share or density of inhabitants, can be reasonably used;
- fourthly that there is a very close relationship between the division of assets and debts; and
- fifthly, that the selection of more than one simple method of division may still require the need for broader principles of efficiency and relevance to be applied if a division is to be equitable.

The historical examples allow us to draw three conclusions for the purposes of debt division in the cases of state succession.

- Firstly, they show that there is no standard or internationally historically used method of division. In each case, a different method or series of methods was used. It is perhaps then not surprising that when Quebec considered independence in 1995, four different approaches to debt division were outlined (division by population, GDP, a Bélanger-Campeau formula, and historical contribution).
- Secondly, the historical examples show that in all cases of apportionment or planned apportionment a combination of factors were used, rather than the application of one single measure. In the case of Russia, the debt was

originally going to be allocated using a formula based on a combination of demographic and macroeconomic factors, whilst in Yugoslavia and Czechoslovakia a number of different methods where used depending on the type of debt and whether this was an allocated or non-allocated obligation.

- Thirdly, the historical examples clearly show that the parties to negotiations do in fact work towards an equitable division, taking into consideration both what is most expedient and most relevant. And the division of state assets is crucial to achieving this.

Applying the historical methods of division outlined above to the Scottish independence debate on debt allocation shows that at present, current proposals for apportionment are not in entirely in keeping with recent state practice. The Scottish government has outlined the possibility of applying either a historical contribution or a population share method of division. If followed, and one method was to be used across all debts, it would signal a break from past practice, where states have distinguished between territorial and non-territorial debts, and applied different allocations to these accordingly. In its recent *Outlook for Scotland's Public Finances*, it did however indicate that it would possibly follow international practice regarding territorial and non-territorial debts. Furthermore, the historical contribution method, whilst a contributing factor to the IMF Key used in Yugoslavia, has not been used as a single, stand alone, method of division. As the UK government has refused to outline its preferred method(s) for debt division, the report is unable to assess whether it would be in keeping with recent historical examples.

4. Issues arising

A comparative analysis, in addition to identifying possible and even likely methods of debt allocation (outlined in section five below), provides insights into possible issues or considerations arising from past experiences of dividing debts in cases of state succession.

The greatest historical challenge perhaps is the fair and proportionate linking between the allocation of debts and assets. This principle is included in the *Vienna Convention*, whereby equitable allocation of debt necessarily takes into consideration the extent to which assets pass to the successor states. Interestingly, whilst recent state practice confirms this, recent creditor state practice rejects it. In the case of the USSR, the creditors insistence on joint and several liability showed their indifference to the allocation of assets, as most tellingly evidenced when the creditors refused Ukraine's specific request to receive equitable allocation of Russian assets or have the level of debts revised to reflect its actual share of assets. Similarly, in Yugoslavia, the creditors showed an indifference to the allocation of assets when dividing the debt. They simply took no consideration of the fact that none of the successor states except Serbia/Montenegro had access to the assets of the former Yugoslavia. Nevertheless, state practice supports the principle that debt allocation needs to be seen within the wider context of asset allocation too. In the USSR, successor states agreed that there had to be a link between the allocation of state assets and debts, and in the subsequent zero-sum agreements between Russia and the successor states, the latter agreed to being freed from debt obligations in exchange for denying any entitlement to former USSR national assets. In Czechoslovakia, the two successor states agreed to apply the same method for allocating debt to the allocation of assets, taking into account particular exceptions (e.g. the location of fixed military installments). A challenge for the UK, as already clearly expressed in public debates surrounding a sterling currency union, will be the appropriate linking between debts and assets, and the offsetting of one against the other in instances of particular negotiations (discussed at greater length in section 5). This is a highly complex area that also crucially includes issues such as finding an agreement on what constitutes a debt and an asset, and how to value them.

A basic challenge in historical experiences of debt allocation is finding agreement between the parties on defining and valuing debts and assets. In the USSR, a separate commission was established to fulfill this task resulting in an *Agreement between Heads of State of the CIS on Property of the Former USSR Abroad*. In Yugoslavia the parties were unable to reach a mutually acceptable valuation

of federal assets. To make matters worse, an independent team of consultants commissioned by the European Community to value federal assets was imprecise. From the political discussions in the UK to date it is clear that there would be disagreement in the UK too as to how to define and measure debts and assets. The Scottish government has taken the view that the sterling currency is an asset, a conclusion flatly rejected by the UK government. There is also no reason to believe at present that the Scottish and UK governments would agree on the valuation of assets. Past state practice (and failure) supports the merit in the establishment of joint commissions to value and allocate debts and assets. These are almost a necessity given the complexity of the task and the requirement in international law and practice for consensus between the parties. The creation of such a joint commission raises its own issues however, including questions regarding its membership, independence, remit, accountability, legitimacy, and capacity to resolve conflicts.

A further challenge is the establishment of a process for debt division and management. The likely creation of a joint commission for valuing and dividing state assets and liabilities is already mentioned above. In addition to this, there is the need for a wider framework within which both the commission and subsequent implementing institution(s) will work. In the case of the USSR, when the breakup was being treated as a dissolution of the state, a series of protocols and rules had to be agreed along with the establishment of a new institution, the Interstate Council, for the supervision of the servicing of debt, the collection and possible sale of foreign currency debts and other assets, and the administrative oversight of the debt management bank. Whilst there are clear limitations to using the USSR as an example for the United Kingdom, not least because in the United Kingdom there would only be one successor state, it nevertheless brings to the fore some very real and practical systems that need to be created to provide for good debt management. If Scotland secedes from the United Kingdom, part of any future negotiations would have to include discussions and agreements on rules governing repayment, as well as a consideration of whether such a debt would be managed by the United Kingdom's Debt Management Office or some newly created administrative institution. The parties may also need to consider the merit or even the necessity of international oversight of such a process to reassure the parties, and perhaps more importantly, the creditors, that repayments were being made in a timely and proper fashion.

As part of the above process oriented provisions, mechanisms for managing disagreements between the parties would most likely be needed. Historical examples demonstrate the importance of getting this right, as well as the consequences of getting it wrong. In Yugoslavia, the successor states could not

agree on the allocation of debt obligations, or a dispute resolution mechanism. This resulted in the creditors deciding on the measure of debt division in the end. In Czechoslovakia, the Constitutional Law of both newly independent states ensured the creation of a commission to settle claims. The commission had an equal number of representatives from both successor states and was governed by a set of rules agreed by the parties. Making arrangements for resolving future disputes is sensible and this would most likely require the establishment of an independent adjudicating body. However, this will require the parties to agree on its membership and election, the role, if any, of international parties, the scope of its remit, and the rules and procedures governing its processes and procedures.

A further consideration, drawing specifically on the example of the USSR and Yugoslavia, is whether any provisions would need to be made for joint and several liability. This means that both parties are fully responsible to the creditors for the entire repayment of the debt regardless of their apportioning of it. This protects the creditor as if one party fails to repay the debt, or is unable to, the creditor can still seek it from the other party In the case of the USSR, the creditors originally insisted on Russia being held joint and several liable for the overall debt in order to safeguard repayment in the event that a successor state defaulted. In the end, the debt was not allocated but remained in its entirety with the continuing state of Russia. However, this raises the question of whether creditors, or for that matter, the remaining UK government, would seek to strengthen any separate agreement on debt allocation between Scotland and the UK by inserting such a clause. For the creditor, it would provide the additional guarantee of repayment through the Scottish economy, and more particularly North Sea oil revenues, while for the UK government it would reduce market perception of debt liability and risk, and therefore maintain or reduce the cost of borrowing.

The latter consideration also raises the important role creditors can play in debt division. In both Yugoslavia and the USSR, the creditors were actively involved in the debt allocation process, contrary to the principles laid out in the *Vienna Convention.* In the former case, creditors decided the method of division whilst in the latter, they insisted on joint and several liability. Moreover, in the case of the USSR, the creditors played a significant role in influencing the outcome of disagreements between the negotiation parties, as evidenced when credit states refused to accept Ukraine's request to independently service its share of debt. Czechoslovakia was the only case where the creditors did not direct the division of debt. In the UK debate so far, there has been little consideration of what role the creditors may play in any final debt settlement. The Treasury simply announced to the markets and creditors that it would continue to hold the liability for the debts. Equally, the Scottish government has simply announced that it would not accept

liability for a proportion of the debt if the remaining UK refused to enter into a sterling currency union with it. Neither of these positions gives proper attention to either the potential desire or the capacity of creditors to influence the final settlement. Creditors may make their own demands should Scotland wish to vote for independence and this might have consequences both for the method of division, as well as the legal liability, administration and management of it.

Historical examples demonstrate the complexity of debt allocation. Some of those issues and challenges have been outlined above but these are by no means exhaustive. Nevertheless, past experiences clearly show that part of any debt allocation arrangement will also have to include agreements on:

- what constitutes a state debt and asset;
- what is a fair and proportionate linking of debts and liabilities;
- what is an appropriate mechanisms for valuing them;
- what is a workable set of rules and principles for processing the allocations; and
- the establishment of institutions for implementing processes, monitoring repayments, and resolving disputes.

Crucially, all of this will need to be done within the context of the needs and desires of interested and influential creditors, which has the potential to present its own challenges.

5. Scotland and the UK

The legal and historical contexts make it clear that debt allocation in cases of state succession is a matter for negotiation. As such, whilst the contexts are helpful for highlighting emerging patterns, as well as the likely challenges, and likely processes, they have an inherently limited applicability. In the event of independence, Scotland and the remaining UK would need to find a solution to debt allocation which accurately and sensitively reflects not only their particular joint history, but also their particular present politics and interests.

a. An independent Scotland would accept liability for a share of debt

An independent Scotland would accept liability for the repayment of a share of UK debt. This is not a legal but practical, and common sense observation. Accepting a share of national debt would clearly be in the best interest of Scotland itself.

Any future independent Scottish government, regardless of its political hue, would wish to quickly establish an international reputation as a responsible and reliable nation. Accepting a share of the debt is part of the way by which this is achieved. Ukraine insisted on receiving debt precisely for this reason. A refusal to accept a portion of liability for debt incurred while part of a union would undermine efforts to build relations and partnerships with other nations or organisations such as the European Union, raise doubts in the minds of potential trade and business investors, and increase the cost of government borrowing.

On the latter observation, while the Scottish government accurately notes that a failure to accept a portion of liability technically would not be a default on payment (assuming one follows recent state practice (USSR) rather than the *Vienna Convention* in relation to the allocation of debt in cases of continuing states), the Scottish government nevertheless fails to address how this action would be perceived by the markets. Jeffries Investment Bank has estimated that the cost of borrowing would increase by 5% in the event that Scotland becomes independent and refuses to take a share of the debt burden.

For these reasons, in the event of independence, Scotland would undoubtedly accept a share of liability for national debt, regardless of its potential position under international law and regardless of the sterling currency union. Plain and simply, it would be against Scotland's political and economic interest not to accept the debt.

b. Method of transfer

HM Treasury in its statement to the markets, *UK debt and the Scotland independence referendum*, announced that existing debts would be honoured by the remaining UK, and that a separate agreement would be entered into between the remaining UK and an independent Scotland for a repayment of a fair and proportionate share. From the UK government's perspective, this is the logical result of the remaining UK being considered a continuing state and an independent Scotland a successor state. The Scottish government believes this is negotiable, whilst simultaneously acknowledging that in such circumstances, if the remaining UK is recognised as a continuing state, then the remaining UK could be solely liable for the debt.

The legal status of the remaining UK and of an independent Scotland is significant for the method of transfer of debt. If the UK is deemed to have dissolved (that is to say, ceased to exist as such, and be reconstituted as a new state along with Scotland) then the existing pool of debts would be divided directly between the two newly independent states according to tripartite agreements entered by the reconstituted UK, newly independent Scotland and the creditors. This is what happened in Yugoslavia and Czechoslovakia as discussed earlier in this report. However, if one of the states has not dissolved, then the debts can be either divided and transferred (as per the *Vienna Convention),* or remain held by the continuing state (following recent practice in the USSR), with separate bilateral agreements being made. The UK government suggests it prefers the latter option. Significantly, whilst from a legal perspective the status of the successor/continuator states informs the debt allocation, in practice, debt allocation is used to influence a decision on the status of the states. As such, debt division has broader negotiation value, as will be discussed further below.

The Scottish government's Fiscal Commission Working Group in its *First Report – Macroeconomic Framework*, outlines three possible means of transferring the agreed amount of debt: first, through a direct transfer of the debts to Scotland, second, through a transition mechanism where the debt remains with the UK and Scotland repays its share of the debt in installments (pay the interest on outstanding debt until maturity than repay the principle) and third, a similar transition mechanism, however it would be followed by the joint issue of sterling bonds. The Fiscal Group does not recommend one of the options, but the Scottish government's *Scotland's Future* repeatedly alludes to the second option, indicating that this is the government's preferred mechanism.

It would be in the remaining UK government's interest to seek an immediate and full payment of an independent Scotland's agreed share of debt. This would lessen its risk profile (e.g. avoids the danger of Scotland deferring or not repaying its debt), and reduce its net debt. An independent Scottish government's interest would be to agree a payment schedule, allowing it on the one hand to demonstrate responsibility and help build its own credit history, whilst on the other hand, assuming the debt gradually, reducing its risk profile to the markets and consequently the likely increase in cost of borrowing. Importantly, creditors could also take a keen interest in the negotiations and could influence the shape of any arrangement entered into.

In view of the difficulties involved in directly transferring the debts, the likelihood that the remaining UK will be considered a continuing state by the international community, the UK's desire to be considered a continuing state, the UK government's readiness to maintain the debt and enter into a separate agreement with Scotland, and the likely inability of a newly created Scottish state to raise the necessary amount to repay the remaining UK in one payment, it is almost certain that the second or third of the Fiscal Commission Working Group's options would be followed. Nevertheless, as noted by Professor David Bell, "there would clearly have to be very tight legal agreements between both governments on the allocation of serving costs" and some provisions made for how the governments would respond should the UK decide to reduce the overall value of its debt.

c. Cost of transfer

There would be costs associated with the remaining UK and an independent Scotland entering a separate agreement whereby Scotland would repay the UK for its share of the debt. Both the UK and Scotland will have administrative costs related to the payments (although these should be relatively insignificant). In addition to this, the UK may incur higher borrowing costs as a result of shouldering the entire burden of the debt, and thereby increasing its debt to GDP ratio. The National Institute for Social and Economic Research has estimated that following a geographical share of oil and gas and a population share of the debt, the remaining UK could expect to see its debt to GDP ratio increase by 9%.

This would add to the UK's risk profile as creditors security is lessened by both a greater debt to GDP profile and the risk of payment deferral from Scotland. Fitch Ratings expressed the view that in the event of Scottish independence, that "there would be additional, albeit likely moderate, risks for the UK." in a special report published in April 2014. This is based on their calculation that if Scotland

became independent in 2014, and the UK government shouldered the entire existing debt burden, it would result in " a one-off increase of 9.5% of GDP in the UK gross public debt ration". Moody's, the credit rating agency, also confirmed in May 2014 that in their view "any credit impact (negative or positive) from Scottish independence on UK sovereign creditworthiness is likely to be limited but that it would have a negative credit impact should Scotland refuse to assume a "fair and proportionate share" of debts."

The extent of the risk increase - and so the associated cost - is hard to assess in advance as it would depend on the agreed timescale of repayment, the mechanism and instruments used to secure repayments, any risk mitigating clauses in the agreement (such as joint and several liability for the debt), the global economic outlook, and perceptions in the international community as to the political and economic capacity and the will of Scotland to make the repayments.

As part of the negotiation, it is probable that the remaining UK government will most likely seek to offset these costs. These costs are impossible to accurately quantify or describe in advance of the negotiation, but it would be reasonable for these costs to be offset in any agreement and should be recognised as adding to an independent Scotland's debt liability.

d. Measure of debt

There are many different means of measuring a nation's debt, all of which produce varying burdens. As part of any future negotiations should Scotland vote for independence, the parties would need to agree which measure of debt to apply any agreed method of division against. This will clearly have implications for Scotland's share as this will necessarily correspond to the higher or lower agreed overall debt.

The three measures of debt that might be used are public sector net debt, public sector gross debt (or the Maastricht definition) and whole government accounts. Public sector net debt is calculated by adding government bills and gilts and National Savings debt, and subtracting government liquid assets, measured on a cash basis. This is a narrower measure of debt which is most commonly used by governments. Public sector gross debt, or the Maastricht definition of debt, is a wider measure of debt as it does not exclude public bodies debts nor include government liquid assets. This is the measure most commonly used internationally. Finally there is the debt measured by whole government accounts. This is the widest measure of debt as is the consolidation of all government departments and includes accruals arising from past activities such as public sector pensions. As

table 2 below shows, the different measures produce quite different levels of debt, ranging from £1,104 billion to £1,347 billion in 2011-2012 alone.

Table 2: Alternative measures of UK public sector debt

	2011-12		2013-14		2015-16	
	£bn	%GDP	£bn	%GDP	£bn	%GDP
WGA (Net liabilities)	1,347	87	NA	NA	NA	NA
PSND	1,104	72	1,258	75	1,439	79
Maastricht definition	1,312	85	1,512	90	1,701	93

Source: OBR (2014) and HM Treasury (2013) produced by NIESR

Significantly, whole government accounts offset total government bodies' liability (including accruals arising from past activities) against total assets. According to the UK Whole Government Accounts, quoted repeatedly by the Scottish government, the UK's government total asset value is £1,268bn. This figure is in accordance with the Net Asset Register published by the UK government in 2007, and based on valuations from 2005. Clearly this is now outdated and would need to be revalued in light of changes over time. As such, whilst the whole government debt is a helpful indicator of the approximate level of debt, it does not provide a conclusive and workable figure.

Whilst it would remain a matter for negotiation, it seems likely that the parties will agree to discuss debt division on the basis of the widest measure of debt – although current whole government accounts cannot be used as the basis for this for the reason given above. This is consistent with international and domestic principles of fairness and equity as it would be difficult to make a case that an independent Scotland should only receive a share of a portion of the debt amassed when part of a single union. More importantly perhaps, from an independent Scottish perspective, it would support the view that the negotiations were part of a final status settlement, and help build its reputation in the international community and markets as a responsible and reliable independent nation. From the perspective of the remaining United Kingdom, it is difficult to conceive any negotiator settling for less then the widest measure of debt.

Whilst the widest measure of debt would likely be negotiated, it is suggested that different types of debt will be treated separately in any future negotiation, with different methods of division being applied to territorial and non-territorial debts, as well as between present and future obligations. It is argued that this would be

a reasonable way to proceed given its potential to both simplify and communicate effectively to international markets what would be of most relevance to them whilst simultaneously enabling the respective governments to treat the debt question within the framework of much wider succession discussions, including currency union, Trident, EU membership and costs associated with decommissioning oil and gas platforms.

For current debts, the Maastricht definition is a helpful measure as it is used and accepted internationally and is not contingent on the valuation of assets. It is also the measure referred to widely and repeatedly in technical assessments of debt division between Scotland and the remaining UK by credit rating agencies and economists and is in line with an independent Scotland becoming a member of the EU as it uses this measure to assess an applicant's fiscal position.

For future expected liabilities from past or present commitments, the negotiators will also have to find agreement on how to divide these. This will most likely be treated differently as discussed below.

e. Most likely method of debt division

In *Scotland's Future*, the Scottish government outlines two possible methods of debt division: allocation by historical contribution and by population share. More recently, the Scottish government has stated in its *Outlook for Scotland's Public Finances* that it "envisages that a negotiated settlement for debt payments would ultimately lie within the bounds of a per capita and zero share range. This will not only reflect Scotland's historic contribution to the UK public finances, but also the likelihood that Scotland would be unlikely to want (or need) to taken on a per capita share of certain existing assets (e.g. defence and non-Scottish physical assets)". There are also other options available such as division by GDP, or by a formula that captures a number of various historical and economic issues. Additionally, when considering debt allocation, historical cases of state succession as those discussed above often show that a number of different methods are applied according to the nature of the debt and whether it is possible to identify it to a region. Whether this would be followed in the UK and Scotland and if different measures would be applied to differing debts would all form part of the negotiations. Nevertheless, based on historical comparisons, the particularities of the UK position, the likely dynamics of any future negotiations, and the international context in which they would be set, we shall in what follows consider methods of division as applied to three measures of debt: existing identifiable debt, existing non-identifiable debt, and future identifiable and non-identifiable debt.

Existing identifiable debt would most likely be divided according to the location in which the debt can be identified with. The underlying assumption being that if the debt was issued for the purposes of funding an identifiable project or initiative in a particular region or location (e.g building a particular bridge) then the repayment should be allocated to the region in which the particular project or initiative was in. An identified debt is one that has been issued by a local government, and/or by the national government for a local or regional area with a specific aim to benefit that area or address a local issue. It takes into consideration both the territorial and final beneficiary aspects of the debt. This method was used in Czechoslovakia and Yugoslavia. It is a pragmatic method of division for those debts that can be identified with a region.

Existing non-identifiable debt (the vast majority of national debt) is more complex to divide.

The Scottish government has suggested applying a historical contribution method to apportioning the debt. This seeks to divide the debt by assessing the combined deficit between Scotland's contribution to and spend from the UK government. Their calculations begin from 1980 onwards, on the basis, they argue, that "as approximately 90% of UK public sector net debt has been incurred since 1980, assessing Scotland's fiscal position over this period gives an indication of the amount of the UK net debt which has been incurred on behalf of Scotland." Importantly, this approach considers tax revenues from North Sea oil and gas as Scotland's contribution to the UK. This reduces Scotland's portion of the UK's debt burden substantially, as both the level of production and value of oil and gas increased from 1980. Jim and Margaret Cuthbert in *Issues surrounding the sharing of the UK debt post independence*, goes further in applying the historical contribution method, and argue that Scotland would have accumulated significant net assets (rather than debts) of £148bn between 1980 – 2012 from oil and gas revenues. Whilst on one level this is an appealing and apparent fair method of division, on another level it presents a number of real difficulties. These include practical matters such as agreeing a start date for the assessment, accessing accurate financial data, and assessing non-financial benefits such as the UK's international profile in the United Nations. There is also the thorny issue of how one would attribute contributions and costs to a region when they were not historically considered to "belong" to one region or another. For these reasons, along with a lack of a convincing historical precedent for this method, it is unlikely to be applied.

Another potential method of division is the use of gross domestic product. According to this approach, the existing non-identifiable debt would be apportioned in line

with Scotland's financial means as calculated on the basis on its annual domestic product. Applying this method would result in Scotland receiving a greater share of the debt then would be the case under either a historical or population share (discussed below). This is because of the significant income generated through gas and oil production. This method however raises significant questions surrounding how one would incorporate anticipated loss of income resulting from Scotland's dwindling oil and gas fields. The latter is particularly pertinent if Scotland is not to receive an overly burdensome share of the debt. Given the complexities, as well as the lack of historical or current political support for this approach, this method is also highly unlikely to be followed.

The creation of a "key" or "formula" to divide the debt is also a possibility. This would allow for a combination of factors to be considered resulting in a more nuanced approached to debt division. A key could incorporate aspects of the measures described above such as historical contribution and GDP, as well as other factors such as population and asset distribution. This approach has the arguable benefit of taking a more holistic approach which considers the particularities of the historical union, as well as the practicalities of present and likely future economics and demographics. There is historical support for this method as well. The IMF devised a "key" which was used in Yugoslavia. And in the USSR, when it was originally being treated as a dissolution, a formula based approach was also taken. Importantly however, there has not been any notable support for such a method being used in the UK should Scotland vote for independence. It would seem that this marked lack of enthusiasm from economists, accountants, experts, government officials, the markets, and politicians, rests on a deep desire for a simple approach to debt division. It is clearly not in the best interest of either the remaining UK or of an independent Scotland to have a complex, highly technical method of debt division because it risks prolonging the negotiations and creating uncertainty as to both the result of the debt division and the reasons for the apportionment. Somewhat tellingly, in the case of Yugoslavia, whilst the results of the IMF key are publicly available, the method for calculating them is not. This increases the challenges for markets when assessing whether the debt burden acquired is fair and proportionate.

The most likely method for dividing existing non-identifiable debt is by population share. This method simply divides the whole debt in proportion to the populations of an independent Scotland and remaining UK, so that Scotland would receive a per capita share of the debt. Applying this method, Scotland would receive 8% of the overall debt. This is less than the GDP share, more than a historical contribution share, and cannot be compared to a "key" method of division as that would need to be negotiated. The population share method provides a simple

approach. As a method it also has the advantage of being easily explainable to the markets and to citizens, and benefits from receiving widespread support from economists, government officials, politicians, and the markets. Significantly, Scotland's First Minister outlined it as a possible means of dividing the debt. The approach has been successfully implemented elsewhere, as discussed earlier in relation to Czechoslovakia, adding to the likelihood that it would be adopted should Scotland vote for independence.

There are of course potential difficulties with relying on a population share, not least whether the population should be calculated on the basis of the number of those living in Scotland at the time of the referendum or at the time of the declaration of independence. It is not unrealistic to suppose that the population may fluctuate depending on whether independence would create a new influx of people travelling to Scotland to seek new opportunities, or a migration out of Scotland owing to fears or business relocations. If the population increases, then the debt to GDP ratio would decrease (assuming that GDP rises with population growth), strengthening Scotland's position. If the population decreases, then the debt to GDP ratio increase, worsening Scotland's position and providing a higher debt burden. Similarly, differences in demographics (Scotland's population is expected to age more rapidly than the rest of the UK, with smaller immigration projections) may result in an unbalanced debt burden being applied to Scotland. Despite this, population share seems the most likely method of division given its apparent fairness in the eyes of the electorate, simplicity for the technicians, clarity for the markets, and widespread cross party acknowledgement as a possible, if not likely, method of division amongst the politicians.

Obligations relating to future identifiable and non-identifiable debts are equally challenging for any negotiators. These liabilities are significant, with the OBR's Whole Government Accounts showing them at £241bn in 2012-13. Future liabilities include public sector pensions and decommissioning costs for nuclear power stations. They are made difficult at least in part by the inability to accurately cost them. They are further complicated by the fact that future debts which might at first sight seem easily identifiable with a region (e.g. decommission of oil and gas platforms estimated to come in at a cost of £30bn over the next 30 years) and therefore make an initial case for identifiable territorial division, would need to be more rigorously analysed to reflect both the UK's historical investment, but also the benefit received from them.

It is suggested in this report, that no single standard method such as GDP, per capita or formula, would be used for the division of future identifiable and non-identifiable debt. Rather, this would be where the negotiations are the fiercest,

and the deals struck will go beyond debt division per se, and encompass wider independence issues. Other factors which would be expected to be included in this discussion would be the currency union, diplomatic support for Scottish entry into the European Union, an acceptance and recognition by an independent Scotland of the status of the remaining UK as a continuing state, and the management of Trident. Also very significantly, the distribution of state assets would need to be addressed here so that any disproportionate allocation of state assets to either an independent Scotland or remaining UK as part of the negotiations would be offset by a lessening of the other's debt burden. It is believed that these, along with other significant issues will be bartered by the negotiation teams, and exchanges made, impacting the level of future obligations Scotland would accept to compensate the remaining UK for.

There are two reasons why it is believed that future anticipated debts would be divided separately from existing debts and in this much less rigid manner.

Firstly, this report suggests such a division because it means that a quick and simple answer can be given to the markets regarding the division of existing debts, which is one of the crucial measures used for assessing the financial health of a country. Existing gross debts are the primary measure of debt (the Maastricht definition) that the credit rating agencies use for assessing a country's financial debt profile. Should the parties decide to treat all the debts together, then it would confuse different debts, making any outcome muddled and difficult to assess for the markets, who would be most interested in the current debts. Moreover, it would introduce wider independence issues into this discussion, making a simple method of division highly unlikely. This would have the likely consequences of stalling progress on a matter which all parties would want to address quickly, comprehensively and effectively in order to provide clarity to the markets and create the conditions for financial stability. It is therefore both in the interest of an independent Scotland and of a remaining UK that a decision on existing debts be decided and communicated effectively and quickly, in order to minimize uncertainty and reduce the risk of increased borrowing costs. For this reason, it is anticipated that existing debts and future obligations will be considered separately and that wider independence issues will only be introduced into the latter discussion.

Secondly, treating the existing and future debts separately and in the manner described above would make it is easier for the negotiation parties to communicate an acceptable outcome of the negotiations to their constituents whilst still enabling the negotiators room for maneuver. The latter would be potentially more significant for the remaining UK were there might be less appetite amongst the population for concessions to be made to an independent Scotland by their representatives.

By treating the debts separately, and providing a clear and fair answer to current debts (where most attention will be given to by the public and the markets), politicians will be able to negotiate effectively and creatively on future debts in view of wider independence issues where exchanges will need to be made.

In short, the report acknowledges that the method of division would be a matter of negotiation between the parties. Nevertheless, the report believes that the negotiators would most likely approach the differing debts that make up the UK debt burden with different methods of division. This is based on historical precedent, as well as an analysis of what would be in the best interest of both an independent Scotland and a remaining UK. The report suggests that existing identifiable debts would be distributed according to the country to which the purpose of the debt or its final beneficiary of it can be identified with. Existing non-identifiable debts would most likely be divided according to population share as this has historical support, appears to be a fair method of division, and finds favour with politicians, government officials, economists and commentators alike. Finally, future identifiable and non-identifiable debts would be divided in an ad hoc manner – with possible exchanges made - based on wider independence issues such as entering the sterling union, support for membership to the European Union, and recognition of the remaining UK as a continuing state.

f. Likely debt burden

Calculating the overall monetary value that an independent Scotland would likely agree to is difficult in advance of independence, given that this would be a matter for negotiation.

The Scottish government's proposal for a historical share of the debt would result in Scotland accepting to reimburse the remaining UK £115bn (based on the Maastricht definition of debt being applied to 2015/2016 figures). This however does not include liabilities for future debts originating from the past, such as public sector pensions and decommission of nuclear power stations, and for reasons given above, is highly unlikely to be followed.

The National Institute of Economic and Social Research (NIESR) has projected hypothetical debt burdens for the remaining UK and independent Scotland based on three variables: firstly on the measure of debt (Public Sector Net Debt and the Maastricht Definition); secondly the method of division (debt divided by population share or GDP) and thirdly on a population or geographical division of gas an oil. The table below, created by NIESR, summarises their calculations.

		Remaining UK			Independent Scotland		
	Total		Debt/ GDP%	Debt/ GDP%		Debt/ GDP%	Debt/ GDP%
2016/2017	Debt	£bn	Pop basis	Geog basis	£bn	Pop basis	Geog basis
Debt divided on per capita basis							
PSND	1580	1447	87%	89%	133	88%	74%
Maastricht	1820	1667	101%	102%	153	102%	86%
Debt divided on on GDP (geographic oil basis)							
PSND	1580	1424	79%	87%	156	104%	87%
Maastricht	1820	1640	91%	101%	180	120%	101%

Source: NIESR, Scotland's Currency Options.

This shows high levels of debt for both the remaining UK and an independent Scotland under all measures. Accepting the Maastricht definition of debt, for reasons given above, an independent Scotland could expect to agree to reimburse the remaining UK for £153bn or 86% of it's GDP (based on it receiving a geographic share of gas and oil). Whilst this is lower ratio of debt to GDP than the remaining UK (in every measure when oil and are allocated by geographic rather than population share), this remains a significant debt burden. However, these figures do not take into consideration future liabilities, nor do they distinguish between existing identifiable and unidentifiable debts.

Applying this report's expected methods of division to the different debts is difficult owing to three unknowns. Firstly, because in order to calculate the monetary value of existing identifiable debt, it would need to have a view on the specific set of criteria that an independent Scotland and remaining UK negotiation team would agree for identifying debts to a country – taking into account both geographical location and final beneficiary considerations. Secondly, because the report is unable to foresee the conclusion of the negotiations regarding future liabilities, which it is argued would be based on exchanges for wider independence issues rather than on an agreed tool such as population share or GDP. These exchanges will have a total value of £241bn. Thirdly, because it is difficult to anticipate the

amount that an independent Scotland might be expected to pay the remaining UK in compensating for repaying its share of the debt in installments and therefore increasing the remaining UK's risk profile. This could only be able to calculated once a payment schedule and a wider framework were agreed.

Nevertheless, operating on the basis that an independent Scotland would accept at least a population share of the debt (based on the Maastricht definition) and assuming that the identifiable debt will not have a significant impact on this, then an independent Scotland could expect to begin with a debt obligation to the remaining UK of £153bn or 86% of GDP. However, the report concludes that this is a minimal amount, and that this would likely be increased by agreement to reimburse for future liabilities (potentially significant) and for the method of transfer (relatively insignificant cost implications). Precisely how much this would be increased by will depend largely, in the author's view, on the result of wider independence issues, as briefly outlined below.

g. Wider independence issues contributing to debt allocation negotiations

As mentioned above, the allocation of debt, or agreement as to how much an independent Scotland would likely agree to reimburse the UK for debts and future liabilities should it vote for independence, would be decided through negotiation between the remaining UK and an independent Scotland. While it is reasonable to anticipate the measure of debt, the method of transfer, and the tools that might be used for dividing the debt, based on previous experiences of state succession, and an assessment of the particular UK position, it is nevertheless important to recognise that the debt discussion would take place within a wider and very particular negotiation context. As such, there are other issues that will impact the final outcome of negotiations on debt allocation or agreements on reimbursements. The main external contributing factors are outlined below as: timeliness, equity and expediency, foreign affairs, and domestic politics. Importantly, this report argues, for reasons given above, that the impact of these factors will be limited to future identifiable and unidentifiable debts.

Timeliness

A hugely important external contributing factor would be the need for a timely and decisive answer to the debt question to secure financial stability on both sides of the border. The international community, international organisations, and in particular creditors, credit rating agencies and the markets will want to see a

quick, comprehensive, clear and workable conclusion to the negotiations. Failure to deliver this by the negotiators would potentially result in a destabilisation of both economies, as markets' confidence would lessen following growing uncertainty surrounding the allocation of debt. A desire to prevent this from happening would put pressure on both an independent Scotland and the remaining UK to reach a deal on debt division, or reimbursement, in a timely fashion.

The remaining UK would arguably enter the negotiations in a stronger position, owing to its long, strong, and impressive credit history, as well as the Treasury's recent statement that it would honour all obligations should Scotland vote for independence. It has therefore provided the markets with some clarity regarding its debt profile and has committed to meeting its pre-existing financial obligations.

An independent Scotland, however, would be in a weaker position. As a new country with no credit history of its own, it would be keen to reassure the markets of its financial seriousness and stability in order to receive a favourable credit rating and lower borrowing costs. In order to do this, an independent Scotland would most likely want to reach agreement quickly, decisively and with a clearly understood formula. This would lessen the Scottish negotiation team's room for maneuver in the negotiations, as it would matter more for them than for the remaining UK to arrive to a quick conclusion, increasing therefore the possibility that it would accept an offer sooner than the remaining UK. In short, the Scottish negotiation team would be unable to conduct detailed or protracted negotiations, as well as using stalling methods to pressure the remaining UK into a more advantageous deal. Therefore, the external pressure to reach a quick and clear agreement on debt would most likely result in an independent Scotland accepting a higher level of debt than it might otherwise wish to (such as a division based on historical contribution) in order to send a strong and convincing message to the markets that an independent Scotland is a centre for financial stability.

As part of this pressure, creditors wishing to safeguard their investment might also want to be more directly involved in the negotiations on debt apportionment. This was the case in Yugoslavia. But by contrast, creditors ended up having little influence in the final agreement in the case of Czechoslovakia. This report is confident that in the particular case of the UK, whilst creditors would undoubtedly be engaged and interested, they would not play a direct role or have a direct influence in the final outcome. Rather, it is believed that they would accept any agreement made between an independent Scotland and the remaining UK, as there would be sufficient confidence that both parties would fulfill their commercial obligations.

Equity and expediency

The division of assets will also have a significant impact on the debt burden allocation, or the reimbursement that an independent Scotland would be willing to make. The discussion of debt cannot take place independently of a discussion regarding the division of assets. This is as much for reasons of equity (a sense of fairness) and expediency (it is in both an independent Scotland's and remaining UK's interest that Scotland should have a strong, healthy, and vibrant economy, and be able to pay its own way) as the maintenance of global order.

The division of assets will be as much an accounting exercise as a negotiation one, and the parties will have to first produce an accurate inventory of all of the UK's assets, along with corresponding updated and agreed valuations. These assets will then need to be distributed between an independent Scotland and remaining UK, most likely in the first instance by geographic location. No doubt, some exchanges would be made in some cases (e.g. Trident). Interestingly, such exchanges would not necessarily result in a disproportionate allocation of assets to the remaining UK. According to the latest New Asset Register published by the UK government in 2007, based on valuations from 2005, nineteen of the UK government's department's net fixed assets (physical assets) are valued £337bn. Applying a population share, Scotland should expect to receive £28bn worth of property. However, Scottish department buildings alone are valued at £23bn, so it is very probable that a full and detailed register, taking into account other fixed assets belonging to the UK government but located in Scotland, would see a disproportionate amount of state property located in Scotland.

Assets not located in either territory would need to be divided according to an agreed method or formula. These include both physical (diplomatic offices) and non-physical assets (public monies held in foreign investments). If either side received an agreed disproportionate amount of the assets (fixed and non-fixed), then this would need to be offset in the distribution of debt. So, should an independent Scotland receive a greater share of property (based on newly agreed valuations) than a population share, then it would need to receive a debt burden in line with the disproportionate amount - i.e. a higher debt burden. The same would apply if the remaining UK received a greater proportion of state assets than its population share.

The main public discussion of this to date has been regarding the sterling currency and whether this ought to be considered an asset in the traditional sense. The Scottish government maintains that the currency itself is an asset, whilst the UK government rejects this interpretation describing it as a means of exchange. The

Scottish government has consequently said that if the remaining UK would be unwilling to enter a currency union, then it would not be willing to accept liability for its share of the debt. In support of this, the Scottish government has implicitly cited the case of the USSR, where Russia as a continuing state took on all the former USSR's independent republics' debts in order to secure their assets and strengthen their case to the international community that they were a continuing state. The Scottish government has said that should the UK government be unwilling to distribute the assets fairly by not sharing in a currency union, the remaining UK government would remain liable for the debts too. This report does not consider whether or not currency as a means of exchange is an asset for the purposes of state property and succession. However, based on reasons given earlier in this report, it is highly improbable that an independent Scotland would refuse to take a share of the debt should it not enter a sterling currency union with the remaining UK. This would be so even if it is acknowledged that sterling has a significant value to both the remaining UK and an independent Scotland, whether it is classified as an asset or not. As such, should an independent Scotland succeed in entering a currency union with the remaining UK, it would likely increase its share of the debt to reimburse the remaining UK, as it would have received something – be it an asset or something else – of significant value to the parties. Likewise, if an independent Scotland did not successfully negotiate entry into a currency union, then it is likely to receive a corresponding decrease in the value of debt it would have to reimburse the remaining UK.

Foreign Affairs

Another significant wider discussion that would form part of any negotiation, and likely influence the overall debt burden allocation, is the support that either country would be willing to give each other to further their own distinct foreign policy agenda immediately following Scottish independence.

The Scottish government has said that it would like to be a member of the E.U. As Scotland is currently a nation within an E.U. member state, the Scottish government argues that it would not need to formally apply for membership. The EU has never had to make a decision on whether a formal application would be needed by a newly created state that had once formed part of a union with an existing EU member state. Questions have been asked about whether an independent Scotland could receive an automatic membership, while some have gone further and even questioned whether an independent Scotland could even become a member state- including and most controversially by the President of the European Commission. It is reasonable to assume that an independent

Scotland would wish the remaining UK to support its automatic entry into the EU as a significant and influential EU member state. An agreement to support this may involve the remaining UK government putting pressure on an independent Scotland to accept a greater share of liability for debt- in particular liability for future anticipated debts relating to past or current commitments such as costs related to decommissioning oil and gas platforms.

The remaining UK will want to be considered a continuing state, as did Russia following the break up of the USSR This recognition will prevent it from having to renegotiate all its international diplomatic and trade treaties, agreements and partnerships. Failure to achieve the status of a continuing state would have significant implications for the remaining UK. Apart from the administrative burden associated with this, it could also potentially involve huge costs, both diplomatic such as losing its permanent seat at the United Nations Security Council, and economic, such as potentially worsened terms and conditions in bilateral and multilateral trade agreements. While this is primarily a matter for the international community to decide, and would be addressed by the remaining UK through a concerted diplomatic campaign, rather than any agreement with an independent Scotland, it would certainly improve its position if an independent Scotland recognised the remaining UK as a continuing state. As such, this potentially strengthens, or at least balances, an independent Scotland's negotiating position, as it could seek to offset the "value" of such support, against possible acceptance of certain future liabilities, such as a proportion of public sector pensions or decommissioning nuclear power stations.

Domestic Politics

Finally there are five domestic political elements that will have an indirect influence on the division of debt and are worth mentioning.

Firstly, the parties would want to work together to reach a mutually beneficial agreement. This would be in keeping with the Edinburgh Agreement signed by the Prime Minister, David Cameron, and the First Minister, Alex Salmond in October 2012, where the parties agreed to "continue to work together constructively in light of the outcome, whatever it is, in the best interests of the people of Scotland and of the rest of the United Kingdom." This is important for the debt question, because it means that even if one party were to be in a significantly more powerful position, it would not use this against the other to create either an unjust or unworkable debt allocation. Simply put, this would be against the interests of both an independent Scotland and the remaining UK.

Secondly, it ought to be recognised that the political leverage that either of the negotiating teams would have entering into talks after an eventual Scottish vote for independence, would in part be determined by the mandate they receive from the referendum. That is to say, the greater the mandate (i.e higher percent of the population vote for independence), the more powerful the position an independent Scottish negotiation team would have, and the harder it would be for a remaining UK government to seek a more advantageous result for itself. Conversely, should Scotland vote in favour for independence by a small margin, then the Scottish side would be weaker in the negotiations and the remaining UK side would be relatively stronger.

Thirdly, the domestic political landscape, particularly in the remaining UK would also impact on the room negotiators would have for making deals. Should Scotland vote for independence, there would likely be little appetite in the remaining UK to allow an independent Scotland to receive too many concessions, including on the subject of debt allocations. This will add pressure on the remaining UK's negotiation team to agree an apportionment of debt that would not be susceptible to accusations of it having gone "soft" on Scotland or not sufficiently protected the remaining UK's interest. This would most likely be more pronounced with a Labour government in office, as it would need to convince the electorate in England and Wales that it was acting in their best interest, rather than that of Scotland's, where historically the Labour party has received much of its support. Importantly, this is not to suggest that the remaining UK would seek punitive measures against Scotland, but rather to recognize that political parties south of the border will not want to be seen to give too many concessions.

Fourthly, the caliber of the politicians and negotiators from both sides will significantly impact the result of the debt agreement. An independent Scotland would be strengthened by the political strategy and participation of the SNP leadership who have proved themselves exceptionally talented political operators. Similarly, the remaining UK would benefit from a talented pool of potential seasoned negotiators. The choice of strong, strategically minded and well prepared and disciplined negotiations teams by either side would have the potential to impact the outcome of any discussion on debt division substantially.

Fifthly, the negotiators from a Scottish delegation would inherently be in a slightly weaker negotiating position by virtue of the fact that they have no option but to reach a deal with the remaining UK. They would have no other option but independence. This limits their negotiation options and tactics, because if an unsatisfactory final offer were made by the remaining UK, the Scottish team simply would not be able to reject it and abandon Scottish independence. This

would, of course, be exaggerated or lessened by two factors outlined above: the extent of the mandate they receive and the particular skill and capacity of the negotiating team.

The four headings above (timeliness, equity and expediency, foreign affairs and domestic politics) capture only some of the external factors that would very likely influence the debt discussion. It is important to recognize that such a negotiation would not be conducted in isolation, but within a wider and highly complex set of talks where the parties to the discussions would most probably going to make exchanges in an attempt to further their own national interests in accordance with to their own set of priorities. Importantly, this report suggests that the impact of these wider independence issues would be limited to future liabilities arising from past or current commitments.

6. Implications of debt allocation for future Scottish governments

The debt burden of an independent Scotland matters. A high debt burden has the potential to impact its future credit rating and the interest at which it could borrow. This would have implications for the affordability of any future independent Scottish government's borrowing, and therefore any investment in public projects and services. Conversely, a lower debt burden could potentially improve its credit rating, and lower its cost of borrowing. Even countries that have fiscal surpluses, that is, those raising more in revenue than they spend, often borrow. For example, Norway in 2012 had a fiscal surplus of 14.6% of GDP and yet still borrowed NOK 97bn (approximately £9.7bn).

The Scottish government in, *Outlook for Scotland's Public Finances and Opportunities of Independence*, calculated the fiscal implications of agreeing to a historic share of the UK debt interest payments (historical contribution with the IOU option). According to this, "the results imply that, assuming 3% nominal growth in non-debt interest current spending during 2017-18 and 2018-2019, Scotland's net fiscal deficit would fall to 2.2% of GDP in 2018-2019. Alternatively, assuming that this spending fiscal deficit is estimated to fall to 0.9% of GDP by 2018-2019. Increasing this spending by 3% a year would provide approximately £2.4bn in additional resources in 2018-19 compared to a scenario where spending grows by 1%." The Centre for Public Policy Research in *Fiscal implications for an independent Scotland when assuming that it takes on a low, or zero, share of the UK's existing debt* concludes that, "if a low, or zero, share of UK debt can be achieved, whether through negotiation or otherwise, it could substantially improve Scotland's fiscal balance and so strengthen its longer term fiscal prospects."

Assuming an independent Scotland receives a population share of the Maastricht definition of debt (at a minimum), for reasons given in section five, then Scotland would have a lower debt to GDP ratio than the remaining UK. Nevertheless, this would still see an independent Scotland starting with a significant debt burden, estimated at 86% of GDP. This would be a high level in comparison to some other small yet wealthy European countries. For example, this would be considerably higher than Sweden's 53.5%, Norway's 35.5%, and Switzerland's 42.1% debt to GDP ratios. Additionally, the latter two countries incur higher rates of interest on their borrowing (4.3% and 2.7% respectively) than the UK (0.5%), suggesting that Scotland could expect to pay more in interest repayments as an independent country than it does as part of the UK. This analysis is however too simplistic. Credit rating agencies do of course consider a country's existing debt burden

when assessing its financial profile, but they also take into account a number of other factors.

A country's credit rating is calculated on the basis of an assessment of its willingness and capacity to pay its debt. This is done through both a backward and forward looking analysis of a country's past economic and political performance, as well as its future economic outlook. It is preferable for a country to receive a high credit rating as commercial lenders look to this in part when deciding whether to lend money to a government and at what rate to do so. In order to ascribe a rating, agencies commonly look to a number of domestic and international factors, which Standard and Poor helpfully describe under five categories: institutional and governance effectiveness and security risks, economic structure and growth prospects, external liquidity and international investment position, fiscal performance and flexibility, as well as debt burden, and monetary flexibility. It is clear then that debt is only one, but significant, aspect of a country's assessment, and as such assessing its implications must be seen within this wider context. Using Standard and Poor's five categories, this report outlines the particular factors that are frequently noted as likely to either exaggerate or minimize the impact that an independent Scotland's likely debt burden would have on its credit rating and potential cost of borrowing.

a. Institutional and governance effectiveness and security risks

Four factors contribute to the institutional and governance effectiveness and security risks assessment: the effectiveness, stability and predictability of the country's policymaking and political institutions, the transparency and accountability of its institutions, data and processes, the debt payment culture and external security risks.

The Scottish government has gone some way in addressing these in both practical and theoretical ways. Practically, it has reduced its annual deficit and has maintained transparent and accountable institutions, whilst on a more theoretical level it has set out its plans for an independent Scotland through *Scotland's Future* and other government publications. And importantly from a financial perspective, it established a Fiscal Commission Working group to help "the development of a robust fiscal and macroeconomic framework for an independent Scotland."

Despite these positive steps taken by the Scottish government, which are likely to benefit an independent Scotland's financial profile to credit agencies and the international markets, three other factors are likely to be considered. Firstly, Scotland does not have a track record of "managing past political, economic,

and financial crises" – a key consideration in evaluating its institutional and governance effectiveness. Secondly, the prudent financial measures and reforms recommended for an independent Scotland have yet to be implemented, and it remains to be seen as to whether its government would be able to deliver on its plans. Thirdly, and very importantly, there is a lack of a debt payment history. Fitch told the Treasury Select Committee in evidence giving to it for its report, '*The Economic Implications for the United Kingdom of Scottish Independence*, that a lack of a repayment track record would likely reduce an independence Scotland's chances of receiving the same credit rating as the UK, whilst Sir Nicholas MacPherson, Permanent Secretary of the HM Treasury was of a similar opinion that as a new country with no existing debt repayment, it would likely have to pay a premium on its debt. The UK benefits from low borrowing costs in large part due to its long history of repaying debt. The lack of a credit history is repeatedly cited as impacting on an independent's Scotland likely initial rating and importantly has been highlighted as a cause for concern by all three main credit agencies. Equally damaging perhaps, is whether a Scottish governments would have, or be deemed to have, a culture of repayment or demonstrate a willingness to default on its debts. Recent statements by the First Minister, Deputy First Minister and Finance Minister indicating their refusal to accept a share of the UK's debt should the UK not enter a currency union with Scotland, bring into question whether an independent Scotland would have a culture of repayment, regardless of whether this would legally constitute a default.

b. Economic structure and growth prospects

An independent Scotland would begin as a wealthy country by most international standards. Assuming that it receives a geographical share of gas and oil, it would have a higher estimated per capita GDP than the UK in 2014. The Scottish government has published that between 2008-09 and 2012-13 average tax receipts in Scotland were £1200 (14%) higher than the UK as a whole. Indeed, using Standard and Poor's peer comparison for an independent Scotland (for an amended version, see the table below), it becomes clear that its per capita GDP would be in line with Ireland (rating 'BBB+'), New Zealand ('rating AA-'), the UK ('rating AAA') and Germany (rating 'AAA').

Peer Comparison For An Independent Scotland		
2014 estimated data		
Country	**Rating**	**Per capita GDP (US$)**
Ireland	BBB+	48,053
Scotland (Geographical share of gas and oil)	Not rated	47,369
Germany	AAA	43,855
UK	AAA	41,006
Scotland (Population share of gas and oil)	Not rated	39,913
New Zealand	AA-	39,840

Drawing on growth figures from 2013 it is also clear that differences between Scotland and UK are small. In 2013, Scotland's economy grew by 1.6% in comparison to the UK's 1.7%. In 2012, Scotland's economy grew by 2.1%, while the UK's expanded by 2%. This indicates that an independent Scotland's economy would be wealthy with good prospects of continuing growth in line with the prospects of the rest of the UK.

Additionally, the Scottish government has set out a range of measures by which an independent Scotland would be able to encourage economic growth through stimulating productivity. In *Building Security and Creating Opportunity: Economic Policy Choices in an Independent Scotland*, the government outlined a number of policy options including establishing an industrial strategy, and creating a more efficient tax system.

Whilst recognizing these positive pointers, rating agencies, economic think tanks and commentators have raised five main potential risks to an independent Scotland's economic structure and/or growth prospects.

Firstly, anticipated demographic changes have raised concerns regarding the rate at which an independent Scottish economy will continue to grow. In particular, attention has been drawn to projections of a decreasing population size and increasing old-age dependent population. The Office of National Statistics (ONS) estimate in their "low migration" scenario that between 2012 and 2062, the size of the Scottish population will grow by 4.4% in comparison with the UK's 22.8%.

In addition, the Scottish population is expected to age more than that of the UK's, with the median age rising from 40 in 2012 to 46 in 2062 in Scotland, compared to an increase from 39 in 2013 to 43 in 2062 for the rest of the UK. Added to this, the old-age dependency ratio in Scotland is estimated to reach 48% in 2037 while the UK's is predicted to reach 45%. These changes would have an impact on fiscal performance, as will be discussed below, but also play a notable role for determining a country's future economic growth prospects. This is because a decreasing and aging population impacts a country's labour market. According to the ONS calculations, these population variances could result in a growing gap between an independent Scotland's and remaining UK's growth rates, with estimates showing a 2% economic expansion in Scotland in comparison to a 2.4% rate in the remaining UK by the 2062-2063 financial year. The Scottish government acknowledges these risks, and has proposed to address these demographic risks by stimulating population growth through targeted policy making. It therefore projects a population growth of 6.2% between 2018-19 and 2029-30.

Secondly, the finitude of oil and gas also presents a risk to an independent Scotland's economic growth prospects. With revenues generated from gas and oil representing 16% of Scotland's GDP, any significant reduction (apparent or actual) in production would have direct and negative impact on its economic growth profile. Importantly, the Office of Budget Responsibility in its 2013 *Fiscal Sustainability Report* estimated a decrease in revenues from the North Sea from 0.42% of UK national income in 2012-2013 to 0.23% in 2017-2018 before falling to 0.03% by 2040-41. These figures were calculated on a number of assumptions regarding production, expenditure and future prices being processed through a HMRC model for field-level revenues. The OBR's predictions have been revised down since December 2013 too, showing a further anticipated reduction by £300 million for 2016-17. The Scottish government does not agree with this assessment, which it considers too conservative. Instead it projects both higher levels of production and increased market value. Thus, while the OBR forecasts revenues from offshore oil and gas production at £2.9bn for 2016-2017, the Scottish government anticipates revenues of £6.9bn. Regardless of the difference in their respective assessments, markets and credit ratings agencies have expressed concerns regarding declining future oil and gas production in the North Sea. Standard and Poor noted in their recent assessment that his is their key considerations for rating an independent Scotland.

Thirdly, Scotland's disproportionately large financial services sector has been pointed to as a potential risk to its economic structure. Generating 8% of its GDP, employing 7% of its workforce, and with assets judged to be valued at 12.5 times the size of its GDP, this represents a significant risk. It demonstrates an

insufficiently diversified economic base, and greatly exposes Scotland's economy to foreign liabilities and any future financial crisis. Of course, any independence negotiations would involve the division or allocation of financial institutions under current UK government ownership such as the Royal Bank of Scotland and HBOS. This could result in a lessening of this risk.

Fourthly, potential changes in the trading relationship between Scotland and the UK post independence, should this be decided, have been raised as a risk to the economic structure and growth prospects of an independent Scotland. With 49% of Scottish exports going to the rest of the UK, any barriers to trade, such as potential transaction cost in the event that negotiations do not result in a currency union, could damage its economic output. Whilst the extent of this risk is difficult to measure in advance of the conclusion of any final settlement negotiation, it nevertheless remains a clear risk, as a political disintegration will inevitable result in some economic and trade disintegration as well.

Fifthly, potential changes to the scale of Scotland's public sector after independence risk impacting on its economic growth in the short term. Standard and Poor note the disproportionate size of its public sector, citing that it employs nearly a quarter of the workforce, and expect that a reduction of its size after independence would likely detract from Scotland's immediate economic growth prospects.

c. External liquidity and international investment position

Three factors would contribute to an independent Scotland's external liquidity and international investment position: the status of its currency in international transactions, its external liquidity, and its external position in comparison with other countries.

In Standard and Poor's recent assessment, an independent Scotland would perform well on its external position, owing to its economy's relative openness (exports from goods and services estimated at 45% of GDP for 2012, of which 49% went to the rest of the UK) and comparative position in the world (estimated to be around 1% trade deficit between Scotland and the rest of the world, based on Scottish government figures). The analysis also concludes that Scotland does not rely heavily on external financing on an annual net basis, provided that it receives full revenues from oil and gas, as well as the financial sector. Though the status of both of these assumptions would be subject to negotiations with the rest of the UK. However, gross external financing on an annual basis is significant, owing to its large and significant financial sector and would result in a less favourable assessment of its external liquidity. The report compares the financial sectors

percentage of mainland GDP for Scotland (12.5%) to Ireland (5.2%), the UK (4.6%) and the EU (3.5%) to stress this point. Finally the analysis highlights that a failure to enter a currency union with the remaining UK would have a negative impact on Scotland's external liquidity – a union that has been ruled out by the three main political parties in Westminster.

The Scottish government disputes the scale of the financial sector in Scotland. In *Size of Scotland's Banking Sector*, the government concluded that "the size of the Scottish financial services sector as a proportion of the onshore Scottish economy is around 8 per cent – similar to the UK – and smaller than the UK at 6.7 per cent when geographical share of oil and gas output is included." The Scottish government disagree with the UK government method of allocating RBS's and HBOS's accounts, arguing that "RBS "market division" (including its London based investment banking arm) accounted for more than half of its near £1.3 trillion RBS Group Assets in 2012". They also argue that Halifax, as part of HBOS, still have key headquarter functions in Halifax, while BOS Plc is now part of Lloyds, based in London.

Nevertheless, other assessments equally share Standard and Poor's concerns regarding an independent Scotland's liquidity. The uncertainty regarding its currency arrangements, the final status of the financial sector, as well as a lack of historical balance of payments and international investment position, place an independent's Scotland share of UK debt, within a potentially challenging borrowing context. Of course, many factors relating to liquidity are difficult to assess in advance as they are contingent on the outcome of any future negotiations.

d. Fiscal performance and flexibility

An independent Scotland would benefit from a high GDP, and with a geographic share of North Sea revenues, it would generate more per capita than the rest of the UK. In 2011-12, Scotland contributed 9.9% of the UK government's revenues, despite only making up 8.4% of the population. Added to this, Scotland has reduced its budgetary deficit, with Scottish government statements for 2011-2012 showing an approximate 5% deficit in comparison to its 10.4% deficit for 2009-2010. The Scottish government in its *Outlook for Scotland's Public Finances and the Opportunities of Independence* note that between 2008-09 and 2012-13, the net fiscal deficit was on average 7.2% of GDP – proportionally lower than the UK's as a whole of 8.4% of GDP over the same period. And whilst the Scottish government recognises that its annual net budget deficit is at a high level, it explains that this is in line with other advanced economies following the recent financial crisis.

Despite these positive indicators, there are five significant risks to its fiscal performance and flexibility regular cited and outlined below.

Firstly, whilst Scotland has demonstrated an ability to reduce its annual budget deficit, it nevertheless continues to have a slightly higher annual budget deficit than the rest of the UK and spends more per capita than the UK. In 2011-2012, the total spending to the benefit of Scotland was£12,629 per person in comparison to £11,381 for the UK as a whole. In 2012-13, the total spending to the benefit of Scotland was £12,265 per person, in comparison to the UK as a whole of £10,998. Furthermore, in 2012-13 the Scottish deficit is estimated to have been 8.3% of GDP, higher than the UK's estimated 7.3% GDP. The Institute for Fiscal Studies has argued that the additional spending is largely due to spending on public service where overall it spends 18.6% more than the UK,. Whilst it is true that overall spending per person has declined from the 1980s and 1990s levels where it was estimated to spend 15% more than the rest of the UK, other factors suggest that this will not continue to reduce. As such, the higher spending on public services presents a potential risk to an independent Scotland's fiscal performance and a limit to its government's fiscal flexibility.

Secondly, changing demographics threaten to negatively impact both on an independent Scotland's income and its expenditure, further risking an independent Scotland's future fiscal performance. As discussed earlier, Scotland faces lower population growth expectations and a higher old-age dependence ratio. The Institute for Fiscal Studies projects that the variance in population growth would result in a 0.4% GDP growth rate differentiation between Scotland (2% growth) and the UK on the whole (2.4% growth) by 2062-2063. A reduction in growth would result in a corresponding reduction in revenue to a Scottish government, potentially impacting its fiscal performance. Added to this, an expected aging population, as described above, would potentially put a strain on a future Scottish government's fiscal position as it would seek to respond/provide services to its citizens. In short, the public sector tends to be affected by older age groups. The National Institute of Economic and Social Research has projected that by 2060, the cost of pensions will increase by three percentage points, while the cost of health would increase by approximately two percentage points of GDP owing to these changing population dynamics – both of which are slightly higher in Scotland than the rest of the UK. Overall, public spending is set to rise by four percentage points by 2060- a greater rise than in the rest of remaining UK. The expected changing demographics have therefore the potential to result in both a decreasing government income and the need for greater government spending, (estimated at a "tax toll" downward fiscal pressure equivalent to 8.5% points by 2060), therefore negatively impacting Scotland's fiscal performance and flexibility.

The Scottish government recognises the economic risks and implications associated with its changing demographics and expected higher dependency ratio, and situates its changing population profile within a wider advanced economy context. It argues, "an independent Scotland would have the opportunity to develop a distinct strategy to attract and retain skilled workers." It consequently projects that the implementation of such policies would see a 6.2% growth in the population between 2018-19 and 2029-2030.

Thirdly, a reduction in government revenue generated from income tax could potentially impact on an independent Scotland's fiscal position. In 2012-2013, Scotland generated £2,045 per person in income tax compared to the UK's £2,319. The Institute for Fiscal Studies identified shortfalls with Scotland's smaller wealthy population in comparison with the rest of the UK.

Fourthly, the volatility of the oil and gas sector presents a significant risk to Scotland's fiscal stability and performance as it challenges future governments' ability to plan as well as to respond to wider global economic trends and shocks. This would affect Scotland more than the rest of the UK as it relies more on the sector for its income. For the five years up to 2011-2012, income from this sector represented 1.7% of the UK's but 20% of Scotland's onshore tax revenues based on 2011 figures. This means that Scotland is significantly more vulnerable to what is a highly volatile sector. For example, between 1998 and 2008, gas and oil varied between 9 and 18 percent of Scottish output, and perhaps more noticeably between 2008 and 2012 varied from 21 percent to 12 percent of revenues. And variances can be felt on an even shorter time basis. Between the financial years 2008-2009, and 2009-2010, government revenues from North Sea tax fell from £12.9bn to £6.5bn, which, if Scotland had been independent, would have resulted in almost a 5% reduction in direct tax revenue as a share of GDP. Similarly in the financial years 2011-12 and 2012-13, offshore oil and gas production would have varied from £11.3 bn to £6.6 bn. The true impact of this for tax revenues, and therefore fiscal performance and flexibility, is of course wider than this. An accurate assessment would need to also include loss of revenue from supporting industries and any corresponding loss of income tax emanating from a rise in unemployment. In an analysis by the Institute for Fiscal Studies, it is estimated that a $20 fall in the price of oil would result in a half a percentage point rise in unemployment or 11,000 jobs. This would reduce tax revenue for a Scottish government as well as result in higher spending. The Institute for Fiscal Studies in its recent report, *Taxation, government spending and public finances of Scotland: updating the medium term outlook*, noted that "while in the recent past revenues from the North Sea have usually been enough to close the gap between spending and onshore revenues, this was not the case in 2012-2013 and (according to OBR's forecasts)

declines in oil revenues will mean this will also not be the case in the coming years." Therefore, Scotland's heavy reliance on oil and gas presents a risk to its fiscal performance and flexibility as it is heavily exposed to the sector's fast, and often drastic, changes. The Scottish government is committed to establishing a Fiscal Stabilization Fund, similar to that of Norway's. Of course, this would come at a cost, which the Institute for Fiscal Studies, using forecasts from the Centre for Public Policy for Regions, estimate would need to be met with a substantial fiscal consolidation of 5.1%. And whilst this would respond to the exposure in the medium to long term, it would not do so in the immediate and short term as the Fund would be small and therefore unlikely to adequately shield Scotland from an economic shock. As such, Scotland and its fiscal performance and flexibility would likely remain sensitive to oil revenues and this would have an impact on its economic profile in the international markets.

Fifthly, the size of Scotland's financial sector may have serious implications for its fiscal flexibility. This is because smaller countries with large banking sectors tend to implement fiscal policies that secure large fiscal and balance of payment surpluses without relying on foreign borrowing. This is needed in order to generate significant reserves so that it can withstand potential financial shocks. For smaller countries, having a larger reserve is particularly important as they have limited resources and room for maneuver in such circumstances, owing to their smaller tax base. This fiscal policy was implemented in both Singapore and Hong Kong, where between 2004 and 2011 they ran on average annual fiscal surpluses of 6% and 3% of GDP respectively. Given that Scotland is expected to run a deficit of somewhere between 2.8% and 2.4% (Scottish government forecasting) and 5.5% (Citigroup and Centre for Public Policy for Regions) in 2016-2017 alone, it is clear that an independent Scotland would need to radically consolidate its fiscal policy if it is to create the necessary reserves to counterbalance its large financial sector. This would clearly limit its fiscal flexibility in the short to medium term.

The Institute for Fiscal Studies has recently projected that Scotland's net fiscal deficit would be approximately 6% of GDP from 2016-17 to 2018-2019 if Scotland did not implement the fiscal tightening planned for 2017-18. If, however, Scotland was to implement fiscal tightening, and based on a per capita share of UK debt and geographic share of oil and gas revenues, Scotland should expect a fiscal deficit of 5.5% of GDP in 2016-2017, and 2.9% of GDP in 2018-2019. While this would be a significant improvement from the 6% anticipated under the scenario in which Scotland did not continue to tighten its fiscal position, it would still be approximately 3% of GDP larger than the UK as a whole for 2018-19. Furthermore, the Institute anticipated in *Fiscal sustainability of an independent Scotland* that in the longer term, and taking into account the different demographic challenges and

expected reduction in oil and gas production discussed above, and operating on the basis of the Scottish government continuing with their current fiscal policy, have predicted that Scottish debt would exceed 100% of GDP by 2033 and 200% by 2057. This demonstrates the impact that the above factors would have on its fiscal performance if left unchecked, the likely need for change in order to reduce debt either through tax rises or spending cuts or a combination of these, and the fiscal limitations that future independent Scottish governments would be faced with.

Most recently, the Scottish and UK governments have published their own analyses on an independent Scotland's fiscal sustainability. The Scottish government, whilst accepting the demographic, growth and long-term fiscal pressures/challenges, outlines why it believes that independence would allow for a more nuanced and appropriate policy response, securing future growth and prosperity. Importantly, its figures are based on higher anticipated oil and gas revenues, as well as overall economic growth. It is beyond the scope of this report to analyse this. Others, such as the Institute for Fiscal Studies in *Policies for an independent Scotland? Putting the Independence White Paper in its fiscal context* provide considered engagement with this. However, the report observes that credit rating agencies and lenders would have to make an assessment on Scotland's past, present, and most immediate fiscal performance and on this timescale, the concerns above would not be entirely mitigated by potentially intelligent, focused and localised policy making.

e. Monetary flexibility

The relationship between currency and debt has had a particularly high profile in the independence debate and indeed most financial discussions have centered around this. When credit rating agencies and lenders look at a country's financial profile, monetary policy is vital for their assessments as it helps them measure its ability to respond to economic shocks. Typically, this is assessed against three elements: the country's ability to coordinate monetary policy with fiscal and other economic policy, the credibility of its monetary policy, and its impact on the real economy.

It is difficult to accurately assess the impact that an independent Scotland's currency would have on its share of UK debt as the currency itself is a matter for negotiation between the UK and Scotland. At present the parties disagree as to the best arrangement. The Scottish government has stated that if Scotland became independent then it would seek to enter into a sterling monetary union with the remaining UK, involving a joint governance structure of the Bank of England.

The UK government, and the main Westminster parties have repeatedly said that this is unlikely. There are of course a number of currency options available to an independent Scotland ranging from introducing a Scottish pound, entering a sterling currency zone, or joining the Eurozone.

A monetary union with the remaining UK would, in the first instance, most likely reduce the impact of an independent Scotland's initial debt burden. Credit rating agencies and lenders would see the benefits of the monetary union for an independent Scotland both for its reduction in transaction costs, and crucially for its making available to Scotland the Bank of England's sizeable lending facilities in the event of a crisis. This option appears to offer lenders further security, as it would give Scotland access to a currency that benefits from deep capital markets. Moreover, remaining in a monetary union or currency zone would prevent the need for existing debts needing to be redenominated, although Moody's places little significance to this.

The National Institute of Economic and Social Research (NIESR) argue that a broader approach to examining currency options is necessary looking beyond just the issue of transaction costs, and that more attention needs to be given to how an independent Scotland could respond to adverse economic shocks. According to NIESR's analysis, the greater the debt burden inherited by an independent Scotland, the less viable a monetary union would become, as this would provide it with fewer economic levers in a time of crisis. Monetary union would only allow Scotland to change fiscal policy, but not to amend monetary policy or make currency adjustments. The lower its initial debt burden, the less it matters to have all the possible levers available to it, as it could always respond to shocks through an increase in borrowing. Applying this approach, and based on this report's anticipated debt burden for an independent Scotland, along with the Scottish government's stated flexible position on the durability of monetary union for the longer term, it would seem that a Scottish pound would be in the best interests of Scotland, and would more likely reduce borrowing costs the debt burden in the long term.

It would seem then that the implications of currency decisions to debt would be real, significant, and potentially different depending on whether one takes a short or long term view.

7. Conclusions

Taking into consideration the five considerations above, commentators almost universally support the view that an independent Scotland would not receive an AAA rating. Martin Wolf, the Chief Economics Commentator at the Financial Times has said, "A newly independent small country with sizeable fiscal deficits, high public debt and reliance on a declining resource for 12 per cent of its fiscal revenue, could not enjoy a triple A rating. Its costs of borrowing might be far higher than those of the UK." The Centre for Public Policy and Regions at Glasgow University has also questioned the credit rating Scotland would receive. The three main credit rating agencies have also have indicated that an independent Scotland would be unlikely to receive a AAA rating. Fitch Ratings has gave evidence to the House of Lords Select Committee on Economic Affairs saying that given Scotland's lack of a repayment track record, it would unlikely receive a AAA rating, whilst recognizing that the issue is hugely dependent on the terms of an independent agreement on the length of time it would take for the transition to full financial independence for Scotland to take place. Standard and Poor in their assessment in February 2014 stated that the Scottish economy conforms with the profile of a BBB- or higher sovereign rating. Moody's in an announcement in May 2014 suggested that Scotland would likely receive an "A" rating at the outset.

The cost of borrowing for an independent Scotland is expected to be higher than it is for the UK. This is as a result of a greater risk exposure flowing from its lower credit rating, no track record of repaying debts, and a weaker long-term fiscal performance forecast. The Economist has projected that the cost of borrowing for Scotland would be at least 0.7% higher, while NIESR has conservatively calculated that it would pay an interest rate premium between 0.72 and 1.65% more than the UK (based on a currency union and a geographical share of oil, whilst not accounting for Scotland's lack of credit history). Professor Charles Goodhart from the London School of Economists similarly estimates an increase of 1% interest while Jeffries International, a global investment firm, has also predicted a 1% interest premium on independent Scottish bonds over UK gilts. Recently, Oxford Economics in its report, *The potential implications of independence for business in Scotland*, stated that: "it seems reasonable to conclude than an independent Scottish government would borrow at a significant premium to the current UK. That premium would probably be in excess of one percentage point given the scale of the risks and the economic characteristics of an independent Scotland", a view echoed by Citigroup (estimated increase borrowing premium of 125 basis points) and Deutsche Bank (estimated increase borrowing premium of between 130 and 160 basis points).

Assessing the implications of a likely Scottish debt burden for the Scottish economy and future Scottish governments is extremely difficult in advance of any negotiations. Many aspects simply remain unknown – most significantly the currency an independent Scotland would use. Nevertheless, there are some factors that remain unaffected by the negotiations. An independent Scotland would be a small, new and wealthy nation. It would also have a diversified economy boasting strong and transparent national institutions. But it would also be a country with a number of short and long term challenges. In the short term, it would be a country with no credit history, increasing its risk profile to lenders and resulting in a premium in borrowing costs. In the long term, changing demographics, a reduction in oil and gas production, and significant exposure to international finance through the financial sector all endanger its future fiscal performance and stability. These factors would all exaggerate the impact that an independent Scotland's likely debt burden would have on its credit rating and cost of borrowing.

In conclusion, the report takes the view that the level of debt an independent Scotland would most likely receive at independence would very probably contribute to it receiving a lower credit rating than it currently enjoys as part of the union and pay a higher interest rate premium on its borrowing than the UK. The implications of this in turn are that any prudent future independent Scottish government would need to try and reduce its debt through either a reduction in spending, an increase in taxation, or a combination of the two.

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