1. Introduction

1. A very surprising feature of the referendum debate so far has been the way in which the question of the sharing of UK debt has been handled. This topic has been cursorily treated on the Nationalists’ side: and it has actually been used as a strong argument against independence by the ‘No’ side. Witness, for example, a Sunday Times headline “Independent Scotland would face debt disaster”.

2. What we will argue in this paper is that, once the various facets of this complex issue are exposed, then what emerges are some extremely strong arguments for independence. Further, it is absolutely clear that the negotiating position set out by the Scottish government in its recent White Paper (Scottish Government 2013b) is ill-conceived.

3. The structure of this paper is as follows:

   Section 2 concerns the question of how big UK public sector debt actually is. This is not a straightforward question because there are extremely important implications of quantitative easing that are relevant to any debt sharing negotiations.

   Section 3 looks at the principles on debt sharing set out in the UN Vienna Convention of 1983. While this convention has not been formally ratified, it sets out important principles which should clearly inform the negotiations on debt.

   Section 4 considers one commonly proposed approach to debt sharing, based on population shares, and outlines why this approach is unsatisfactory.

   Section 5 examines one of the negotiating positions put forward by the Scottish Government in the White Paper, based upon splitting UK debt in proportion to Scotland and the rest of the UK’s cumulative historical fiscal deficits. We outline various weaknesses with this approach, including a mistake made in the calculation of the relevant deficits.

   Section 6 looks at the important question of how much Scotland would have accumulated as a surplus, if it had taken over a population share of UK debt in 1980, and since then had experienced the same public expenditure and tax revenues (including a geographic share of North Sea oil revenues) as actually took place. Work done by the Fiscal Commission (2013), by Gordon MacIntyre-Kemp (2013) and analysis undertaken by the present authors, shows that the cumulative surplus would be large – of the order of £100 billion or so.

   Section 7 sets out the mirror image position of the rest of the UK. The figures show how, without Scottish revenues, the rest of the UK would have been in an unsustainable position from the 1980s on.
Section 8 discusses the implications for the current independence debate, and for future debt splitting negotiations between Scotland and the rest of the UK. We do not put forward any specific figure for how much Scotland should be compensated by the rest of the UK – or how much debt it should agree to take on. That outcome will depend on complex negotiations. However, it is clear from the material and the analysis in this paper that these negotiations should be informed by a recognition of the size of the cumulative fiscal surplus which Scotland would by now possess if it had achieved independence in 1980: by an acknowledgement of the implications of quantitative easing: and by a recognition of the principles of the Vienna convention.

2. The size of UK public sector debt, and the implications of quantitative easing

1. At first glance, the question of the size of the UK’s public sector debt looks an easy one to answer. The 2013 Budget Report, for example, shows that the public sector net debt of the UK was £1,189 billion, or 76% of GDP, in 2012-13: and on the basis of projections by the Office of Budget Responsibility (published in the same document) this could rise to £1,580 billion, or 85.6% of GDP, by 2016-17.

2. There is, however, a major complicating factor, in the shape of quantitative easing, which must be taken into account before these headline debt figures can be apportioned between Scotland and the rest of the UK (rUK).

3. Quantitative easing is the process, introduced after the 2008 financial crisis, whereby the Bank of England essentially prints money and uses it to buy back UK gilt edged securities: that is, UK public sector debt. The sums involved are very significant: by February 2013, the amount of debt bought back like this was £375 billion, (Bank of England, 2013): that is, 31.5% of total UK public sector debt. These debt certificates can be regarded as sitting in a drawer in the Bank of England: and the interest the government pays on these certificates just re-circulates back to the Treasury.

4. The theory of quantitative easing is that, once the economy is in proper recovery, the quantitative easing process will be put into reverse. The certificates which have been bought under quantitative easing will be taken out of their drawer in the Bank of England, and sold back into the open market, hence removing liquidity from the system. This would prevent any danger of the inflation which might otherwise result from the original printing of money. On this view, quantitative easing is a temporary measure, which will have no long term impact on the headline trajectory of public sector debt.

5. This orthodoxy, however, is now starting to look increasingly unreal. It is now clear that reversing quantitative easing is likely to be a very difficult, and potentially destabilising, process: witness, for example, the instability in world markets that was caused when the US Fed hinted that it might start unwinding its quantitative easing. One problem is that the prices of government bonds are currently buoyed up (and hence interest rates depressed) not just by the actual purchases of government bonds under quantitative easing, but by the expectation of further purchases. Even a modest start to the process of reversing quantitative easing immediately removes the support to the market provided by the expectation of further quantitative easing purchases, and is therefore likely to result in a very sharp rise in interest
rates. This in turn will quite possibly choke off any incipient economic recovery. This sort of problem is now leading some serious commentators to suggest that quantitative easing is unlikely to be reversed: and that the government will simply cancel the debt certificates that have been bought under quantitative easing. For example, Ambrose Evans Pritchard, writing in the Telegraph on 9 August 2013, said "It is what the Bank of England is likely to do here (while denying it)."

6. But this possibility has immense implications for the process of splitting up UK public sector debt between Scotland and rUK. Suppose that Scotland had agreed to take over a specific percentage of the UK’s headline debt: and suppose that, after that deal had been agreed, and Scotland had taken over a specific cash sum of debt, the rUK government simply cancelled the debt certificates that had been bought back under quantitative easing. In these circumstances, the Scottish government would be left looking very foolish. The implication is that quantitative easing must be taken into account in negotiations about debt splitting. The simplest way of doing this would be to recognise the unlikelihood of quantitative easing ever being reversed: and hence to negotiate not about the split of the UK’s current £1,189 billion headline debt, but of splitting the debt after quantitative easing has been allowed for, that is £814 billion.

7. Interestingly, these significant implications of quantitative easing have not been generally recognised in the independence debate. For example, Paul Johnson of the Institute of Fiscal Studies, when appearing in television on 19 November, uncritically put forward the view that Scotland would inherit a share of the UK’s headline debt figure. As far as we are aware, the issue was first identified in Cuthbert and Cuthbert (2013).

### 3. The Vienna Convention of 1983

1. In 1983, a convention drafted in Vienna by the International Law Commission, under the auspices of the UN, set out important principles on how debt should be divided when states split up. This convention has never fully come into force, since it has not been ratified by a sufficient number of states. Nevertheless, it is inconceivable that its basic principles could be ignored in any negotiation on the partitioning of UK debt.

2. The relevant part of the convention is set out in Article 40 as follows:

   "When part or parts of the territory of a State separate from that State, and form a State, and unless the predecessor State and the successor State otherwise agree, the State debt of the predecessor State shall pass to the successor State in an equitable proportion, taking into account, in particular the property, rights and interests which pass to the successor State in relation to that State debt."

3. This establishes a number of important principles: in particular,

   - That the provisions can be over-written by mutual agreement: in other words, negotiation is inherent in the process – there is no automatic rule.
   - That equity should be integral to the process.
   - And that the way the debt is split up should relate, among other things, to the way in which property is divided between the States. But importantly, this is not just any
property, but property which relates to the debt in question. The intention is clearly that it is not property like natural assets which should be taken into account, but the type of property, like state infrastructure, which will have been created by public expenditure in the first place, and hence will have involved the creation of state debt.

4. In the specific case of negotiation between Scotland and rUK, application of these principles would mean that Scotland should not take over any debt in relation to state assets which it is not going to own or utilise. Obvious examples would be Trident, or UK embassies abroad, unless Scotland was directly inheriting some part of the relevant property.

4. Why splitting UK debt on the basis of population is not the right approach

1. One approach regularly suggested to the problem of partitioning UK debt between Scotland and rUK is simply to use population shares. This is, for example, one of the possible negotiating positions put forward in the Scottish Government’s White Paper: it is also the approach that was quoted by Paul Johnson of the Institute for Fiscal Studies in a television interview on 19 November. This approach tends to be popular with pro-Union commentators.

2. There are a number of good reasons, however, why this approach is inappropriate. For one thing, as already noted, the headline UK public sector debt figure has to be adjusted down to allow for quantitative easing. Secondly, in line with the Vienna Convention principles, the split of debt should be informed by the proportions in which relevant public sector assets are transferred to the new States. (Doing this accurately would require a careful audit of the values of all the state assets being transferred. In fact, this would be a relatively easy, if tedious, process, because the UK government currently values all its assets in order to compile the figures which are published each year on the total worth of public sector assets.)

3. But there is an even more fundamental reason why a simple split of debt on a population basis would be inappropriate: and that relates to the question of equity. Equity is another of the important principles in the Vienna Convention. As we will see later in this paper, the way in which the UK has mishandled the revenues arising from the North Sea raises very important equity issues which need to be taken into account in debt splitting negotiations.

5. Why splitting UK debt on the basis of historic fiscal deficits is inappropriate

1. In its White Paper on Scottish independence, the Scottish Government put forward two possibilities as starting negotiating positions on the sharing of UK debt. One is that Scotland might take a population share, which might amount to around £130 billion: the other is that Scotland might take a share equal to Scotland’s estimated proportion of the cumulative UK fiscal deficit since 1980. This would give a smaller figure of around £100 billion. (Note that these figures relate to shares of the headline UK debt figure as OBR estimates that it will be in 2016/17.)
2. We have already seen, in the previous section, why the estimate based on population shares is unsatisfactory. Now let us look in more detail at the approach based on cumulative fiscal deficit. The source given in the White Paper for the cumulative fiscal deficit calculations is another document produced by the Scottish Government (2013a). This in turn uses figures produced by the Scottish Government, which extend the historic government expenditure and revenues for Scotland (GERS) figures back to 1980: (GERS, 2011-12). On the basis of these historic GERS figures, the cumulative fiscal balance for the UK over the period 1980 to 2011 is a deficit of £968 billion, while over the same period the cumulative Scottish balance is a deficit of £49 billion: the cumulative Scottish balance therefore represents 5.1% of the UK total.

3. It is important, however, to look in rather more detail at the way the Scottish deficit figures in GERS have been calculated. Items of expenditure which are not spent directly for Scotland’s benefit are referred to as “non-identifiable”. In order to produce expenditure figures for Scotland published in GERS each year, such non-identifiable items for the UK are apportioned to Scotland, typically on a population share or GDP share basis (depending on the specific class of expenditure involved). One of the most important of such non-identifiable expenditure items is the interest paid on UK public sector debt, which amounted to a cumulative figure of £746.5 billion over the period 1980 to 2011. In GERS, Scotland is attributed a population share of this particular item.

4. This approach, of attributing to Scotland a population share of UK debt interest payments, may be acceptable for the general purposes of GERS: but it is quite indefensible from the point of view of calculating how to share out UK debt. Suppose Scotland had actually been running an underlying fiscal surplus for all or most of the period in question. Then Scotland itself would not have generated any debt. But if Scotland is attributed a population share of UK debt interest payments, this could mean that Scotland is apparently running a fiscal deficit. If Scotland is asked to take on overall UK debt in proportion to the relative Scotland and UK cumulative deficits, then the effect will be that Scotland is taking on debt for which it was not responsible. So splitting UK debt on the basis of historic GERS deficits, where these deficits include an apportionment to Scotland of a population share of UK debt interest, is a classic example of the kinds of mistake that can arise when figures calculated for one purpose are misapplied to another purpose for which they were not intended: and is a completely indefensible approach.

6. **What if Scotland had been independent?**

1. Suppose that Scotland had become independent in 1980, taking on at that stage some reasonable share of UK debt, and the associated interests payments. Suppose that, since then, Scotland had generated the same tax revenues, (including a geographic share of North Sea oil revenues), and had experienced the same levels of public expenditure as actually transpired. In these circumstances, what might the fiscal position of Scotland be now? Would it, for example, now be sitting on a large sovereign wealth fund?

2. This is a question which a number of previous bodies/authors have sought to answer. One was the Scottish Government’s Fiscal Commission (Fiscal Commission, 2013): and another was Gordon MacIntyre-Kemp (2013). This section draws attention to their findings: and also records the results of some further calculations we have undertaken ourselves. In each case, it is assumed that Scotland starts off by taking over a population share of 1980 UK debt.
3. Under the assumptions of paragraph 1, Scotland would rapidly have moved into fiscal surplus (by about 1982) even after allowing for the interest payments on the share of UK debt it had taken over. It would then have been in the position to invest this surplus, on which it would have earned a return. The way in which Scotland’s cumulative balance would have evolved is very dependent on the assumption made about the interest rate earned on this surplus.

4. What the Fiscal Commission assumed was that Scotland would earn a 1% or 2% real rate of return on the surplus. Gordon MacIntyre-Kemp assumed that Scotland would earn a nominal return of 4% throughout (given the very high rate of inflation and associated high interest rates in the early 1980s, MacIntyre-Kemp’s assumption is actually very conservative, and implies that Scotland would on average have earned a negative real rate of interest of – 0.5%). In our own calculations, we have assumed that Scotland earns the same return as the UK government had to pay on one year gilt edged securities: this corresponds to a real rate of return averaging 2.5% over the period. To put these different assumptions in context, it is worth noting that Norway’s sovereign wealth fund has earned an average real rate of interest comfortably over 2% - and that the Norwegian fund is normally regarded as being very conservatively managed.

5. What emerges from the relevant calculations (given these differing assumptions on interest earned on balances) is that by 2011 Scotland could be expected to have a cumulative balance of around £50 billion on the MacIntyre-Kemp calculation, of £82 billion on the fiscal commission lower variant, £116 billion on the fiscal commission upper variant, and £148 billion on our calculation.

6. These figures can be regarded as illustrating the size of sovereign wealth fund that an independent Scotland might now be enjoying, under the above different assumptions on rate of return. These calculations, it is important to stress, assume that Scotland would fully fund its share of inherited 1980 UK debt. They also assume that Scotland maintained the same levels of expenditure on domestic services like health, education etc. that actually took place. They also assume that Scotland fully met expenditures attributed to it in GERS on all the non-identifiable expenditure items, with the exception of any interest payments on UK debt arising after 1980. So, for example, this means that the calculations assume that Scotland is covering a level of defence expenditure equal to its population share of the UK’s defence budget over the period.

7. As has been seen, the results are highly dependent on the assumptions made about the level of interest earned on surpluses as they are invested. Given that Norway has earned a real return of comfortably over 2%, and is still generally regarded as under-performing relative to other sovereign wealth funds, then a real return of 2% or so looks a reasonable, and indeed conservative, assumption. On this basis, Scotland could reasonably have expected to be the owner of a sovereign wealth fund just now of comfortably over £100 billion, and to have no public sector debt.

8. In fact, these calculations are likely to be unduly conservative, for a number of reasons. For one thing, an independent Scotland is unlikely to have spent as big a percentage of its GDP on defence. The implicit assumption in GERS is that Scotland would have spent significantly over 2% of its GDP each year on defence. However, a World Bank study shows that small independent countries broadly comparable to Scotland typically spend much less than this on defence: for example, Ireland, 0.6%; New Zealand, 1.1%; Denmark, 1.4%; and Norway, 1.6%. Further, if Scotland had been independent, then undoubtedly, like Norway, it would have used the licensing conditions for extracting its oil to ensure that more of the associated manufacturing activity, R&D, headquarter functions, and jobs stayed in Scotland. We would not be in the position we are in just now, where Scotland has 80% of the oil produced in
these islands, but only 45% of the jobs: and also where such a large portion of oil profits simply leave Scotland. The knock-on benefits, in terms of reducing net outmigration etc., are also likely to have been profound.

9. There would, of course, have been potential dangers: for example, the danger that the Scottish currency might have become an over valued petrocurrency, with concomitant damage to Scotland’s non-oil economy. But actually the UK itself has been signally poor in managing its own currency (see J.R. Cuthbert, 2013). There is every reason to expect that an independent Scotland could have managed its currency rather more favourably than the damaging regime Scotland was subjected to as part of the UK currency union.

7. The position of rUK

1. In the preceding section, we looked at what the fiscal position would have been, if Scotland had achieved independence in 1980, and taken over a population share of UK debt, but then had experienced the same pattern of tax and spend thereafter as actually happened. This section looks at the mirror image of that analysis: what would the position of rUK have been, under the same assumptions.

2. If rUK had not had access to Scotland’s geographic share of North Sea revenues, its debt position would have been such that it would have had to borrow to make up the difference: and, of course, it would have had to pay interest on this extra borrowing. For the purpose of this analysis we assume that the interest rate paid by rUK on that extra borrowing would be the short term (one year) interest rate on UK gilt edged securities for the relevant year. Since short term interest rates are typically lower than long term rates, this is a conservative assumption.

3. The following chart shows, for rUK and Scotland, the resulting figures for net borrowing as a percentage of the GDP of the relevant country. Also shown in the chart, are the actual figures for the whole of the UK. In calculating the Scotland and rUK figures, the same assumption has been made about the interest rate earned/paid on balances (that is, it has been assumed Scotland would earn the UK one year gilt interest rate on any surplus invested: and the rUK would pay the same rate on any extra borrowing.)
The chart shows that Scotland would have been in surplus every year until 2009: but on the other hand, that rUK would have been in deficit for the entire period except for the two years, 1999 and 2000.

4. The second chart shows the corresponding figures for cumulative surplus/debt again expressed as a percentage of the GDP of the relevant country.

As the chart shows, Scotland would have moved into cumulative surplus by 1982, with its surplus peaking in 1992 at almost 150% of GDP, and still being almost 100% of GDP by 2011. The rUK, however, would have had net debt of over 50% of GDP for almost all of the period from 1980 to 2007, with debt rising thereafter to over 90% of GDP by 2011.

5. Probably the most striking implication of these figures is that, as regards rUK, things could not possibly have followed this hypothetical path. This can be seen most clearly by looking at the net borrowing figures which would have resulted for rUK in the 1980s, under the above assumptions. What the first chart shows is that rUK would have had net borrowing of 5% or more of GDP for each year from 1980 to 1985, with a peak of 7.7% of GDP in 1984. To put these figures in context, in the 1970s UK net public sector borrowing had peaked at 7% of GDP in 1975: at which point, facing a potential run on the pound, and difficulty in raising money in the gilt market, the UK was forced to go humiliatingly to the IMF for a bail out. In the 1980s, rUK would have had much worse borrowing figures than the UK had experienced in the 1970s, and would have had no support from the anticipation of major hydro carbon reserves: in these circumstances it is inconceivable that rUK could have survived the 1980s without experiencing another major economic crisis, and without being forced into a fundamental rethink of its economic strategy.

6. It is of interest to note that the £2.3 billion rescue package in 1976 was at that time the largest call ever made on IMF resources. The terms the IMF demanded were severe: it required large cuts of the order of 20% in public expenditure and cuts in the budget deficit.

7. Overall, it is clear that, without Scotland and its oil revenues, rUK would have been forced to confront its economic demons in the 1980s, and put its economy on a sustainable footing. Because the UK as a whole, cushioned by oil revenues, was able to survive temporarily, it did not face this discipline. The benefits of North Sea oil were squandered on current spending,
with the result that the UK has never achieved a sustainable economic model. This failure was inexcusable, because the danger was perfectly clear, at least to the Labour administration in the late 1970s. This can be seen from the following quotation from a Memorandum put to the Cabinet by the Chancellor of the Exchequer in February 1977: "North Sea oil by itself will not reverse the decline in our industrial performance; the benefits arising from it could even have the opposite result if we do not use them to good purpose."

8. What this means

1. It is worth considering, first of all, two objections which might be raised to the kind of analysis presented in the last two sections. First, why pick on a specific date round about 1980 as the starting point for the analysis? Second, surely bygones are bygones: all that matter from the point of view of sharing out the UK’s current debt is where we are now, not how we got here?

2. It is relatively easy to answer the first of these. In a stable political and monetary union, one might expect some form of equilibrium to result. There could well be a tendency for some areas which possess a natural centre of gravity to benefit from favourable factor and monetary flows: and with other areas, which are either temporarily or permanently disadvantaged, being compensated by fiscal transfers, transfers which are generally accepted as being part and parcel of the operation of a successful union. In such an equilibrium position, there would indeed be little logic in fixing upon one particular historic time point and trying to work out which areas had benefited or not since then. The key point is, however, that the advent of the public revenues from North Sea oil in the late 1970s represented a profound and discrete disturbance to any pre-existing equilibrium. It is therefore perfectly justifiable to select a date close to the advent of North Sea revenues to examine what the impact of the disturbance was, and to consider how events might have developed differently under different constitutional arrangements.

3. The reason that the “bygones are bygones” argument fails is because of the important principle of equity enshrined in the Vienna Convention. The point can be illustrated very clearly by imagining two different possible scenarios.

4. Under scenario 1, which we might call the “properly functioning union” scenario, a finite resource is discovered which lies largely within the territory of one part of the union. In a properly functioning union, it would be perfectly reasonable to imagine there being an unwritten but well understood accord, whereby the fortunate area agrees that its resources should indeed be used for the greater good of the whole union: but naturally, the resource should be used wisely, and invested to help put the whole economy of the union on a sustainable long term footing. In these circumstances, if in due course the area in question chose to exercise its right to self determination, there would indeed be some case for saying let bygones be bygones when it comes to sharing out any remaining debt of the whole union.

5. The alternative scenario, however, represents the case of an improperly functioning union. Under this scenario, there is no implicit accord that the new resources should be used sustainably and wisely. Instead, the central government of the union unilaterally decides that the finite resources should be extracted as quickly as possible to prop up a malfunctioning economy. Steps are taken to conceal from the area possessing most of the resource the
true significance of the value of what has been found. Far from investing the revenues, they are used for current consumption, and help to put back the day when hard decisions have to be made about a sustainable economic strategy for the whole union. And ultimately, having squandered a large part of the resource, and having backed a failed economic model, the union as a whole is left with crippling debts. In these circumstances, the area which is exercising self determination is perfectly entitled to state that, as a matter of equity, bygones are not bygones, and that, in negotiating what share of debt it may agree to take on, recognition should be made of the way in which the implicit pact governing any properly functioning union has been thoroughly breached.

6. The above picture of an improperly functioning union fits only too well what happened to Scotland within the UK. As evidence that the significance of the discovery was deliberately concealed, there is the active suppression of the infamous 1974 report by senior Scottish Office economist Gavin McCrone, which only came to light in 2005 following a Freedom of Information request by the SNP: the following quotation from that report is relevant: “**Even after its discovery, the full significance of North Sea oil was not immediately apparent, and it still remains in large measure disguised from the Scottish public...**” In a similar vein, minutes of the Cabinet meeting of 15th December, 1977 record “**Above all, the creation of an oil fund would play into the hands of the Scottish Nationalists, for whom it would become a major political target**”. In fact, the way in which the UK handled the oil reserves was particularly perverse, since oil was used to prop up a system where the South East of England grew disproportionately, as most other parts of the union declined. It is particularly grotesque, for example, that during the 1980s, the peak years for oil production, Scotland itself suffered net out-migration of around 150 thousand people (M. Cuthbert, 2013). There is no doubt, therefore, that the UK is a classic example of an improperly functioning union.

7. This brings us to the negotiating position Scottish negotiators should take on the question of how much Scotland should be compensated for its lost sovereign wealth fund: and how much UK debt it might agree to take on. We do not put forward any proposed figure: because the outcome will depend on difficult and complex negotiations. But certain principles are clear from the analysis in this paper. In particular:

a) As regards debt, the negotiation should not be about the headline UK debt figure of £1,189 billion, but of debt after allowing for quantitative easing, that is, the smaller figure of £814 billion.

b) Any simple formula-based approach towards splitting debt (based on population share, or historic share of deficit) is unsatisfactory for the reasons analysed in Sections 4 and 5 of this paper. So, in particular, the two starting negotiating positions set out in the Scottish Government’s White Paper are inappropriate.

c) Negotiations should be informed by the Vienna Convention principle that the way in which relevant assets are transferred should influence any partitioning of debt. So, in particular, it is relevant that Scotland should not be taking on debt in relation to assets like Trident.

d) The equity principle in the Vienna Convention, together with the way in which Scotland’s oil assets have been mis-appropriated in a manner which is inconsistent with any properly functioning union, means that bygones cannot be taken as bygones in the negotiations. The sovereign wealth fund of over £100 billion which Scotland would be enjoying, if it had gained its independence in 1980, is indeed a relevant consideration.
8. In the introduction, we said that the issues surrounding debt, when fully examined, in fact represent strong additional arguments in favour of, rather than against, independence. We can now see why this is the case. First of all, the union has proved itself incapable of exercising proper stewardship, either of an irreplaceable resource like North Sea oil, or of the UK economy. Secondly, that the union has failed to honour the kind of implicit bargain of good faith that should exist in any properly functioning union. And finally because, if the Scottish case in the debt sharing negotiations is properly advanced, a newly independent Scotland would not find itself facing any particularly crippling burden of debt.

References:


