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How would an independent Scotland borrow?

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About this report

This report examines how Scotland would borrow if it were to become independent. It looks at how much it could borrow consistently, based on the experience of other advanced economies. It also explores the main factors that would determine how expensive it would be for Scotland to borrow, and the steps an independent Scotland could take to reassure investors and limit increases in debt interest costs.

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Summary

If Scotland were to become independent, one important new function it would need to take on from the UK government is the power to borrow from international debt markets. This would constrain Scotland's fiscal policy because there would be limits on how much it could borrow year after year, and because Scottish debt interest costs would probably exceed rates that the UK could borrow at if Scotland remained in the union. We find that an independent Scotland would struggle to borrow much more than 3% a year, requiring a 4–5% (£6.5 billion–£8.5 billion) consolidation over and above the savings the Scottish National Party (SNP) has already identified. Further, we find that in the current low interest rate environment, Scotland's borrowing costs would be 0.4–0.9 percentage points higher than UK rates. These are not insurmountable challenges for an independent Scotland, but it would be crucial that it took the necessary steps to ensure that its debt was an attractive proposition for investors to ensure that debt interest costs were not prohibitively high.

The Scottish government has very limited borrowing powers as part of the UK. The UK government borrows from international debt markets on behalf of the whole of the UK and repaying the debt is the UK government's responsibility. Currently, spending that is done for the benefit of Scottish taxpayers is much larger than the tax revenues raised from Scottish taxpayers.[1] That is implicitly covered by a mixture of taxes raised elsewhere in the UK and UK government borrowing. Even before the coronavirus pandemic, this gap stood at more than 8% of gross domestic product (GDP). This is a much bigger deficit than for the UK as a whole.

The coronavirus pandemic has shown that countries can sometimes borrow very large amounts – the UK borrowed more than 14% of GDP in 2020/21.[2] However, there is a difference between temporary borrowing in the face of a crisis and borrowing large amounts year after year. No other advanced economy[*] had a deficit anything like as high as 8% of GDP on average between 2015 and 2019. In the past 25 years, the only examples of countries borrowing a higher share of GDP over a five-year period than Scotland's current implied deficit was during the global financial crisis in 2008. Scotland would be an outlier among international peers in having such a large deficit and it would not be possible to borrow that much year after year from international debt markets without costs becoming prohibitively high.

Scotland would need to adopt fiscal policy that international debt markets would view as sustainable. A healthy public finance position would be one in which debt was falling, or at least not rising, as a share of GDP in 'normal times' (outside of crises). This implies that Scotland would need to reduce its deficit to around 3% of GDP each year in normal times. A deficit at this level or below would also be a requirement for joining the European Union (EU). This would mean Scotland would need to implement a substantial fiscal consolidation – around 5–6% of GDP relative to its current position – over the first few years of independence. The SNP has identified savings worth 1.2% of GDP relative to the current position,[3] including spending less on defence, but that

* Defined as members of the Organisation for Economic Co-operation and Development (OECD).

would still leave a required consolidation of 4–5% of GDP (£6.5bn–£8.5bn). The speed at which Scotland would need to consolidate would in part depend on how much of the existing UK debt stock it inherits; this would be subject to negotiation with Westminster. If it negotiated to take on little or no debt, it might be able to consolidate more slowly. However, if Scotland simply refused to accept responsibility for historic debt in an acrimonious divorce, this could be counterproductive by harming Scotland's reputation with international investors, as well as creating other problems.

Assuming that Scotland was able to reduce its deficit to a sustainable level, it would still almost certainly be more expensive for Scotland to borrow than for the UK, as higher interest rates would be needed to attract investors. This is due to several factors:

- All else being equal, small countries pay a premium over bigger countries because their debt markets are less liquid (because there is less debt in circulation) and so it is harder to buy and sell debt
- Initially, Scotland's lack of a track record could be a source of a substantial premium – that is, higher borrowing costs – because investors would take time to be reassured that Scotland would repay its debts
- Scotland's currency choice could also be a reason for higher interest rates as investors may need to be compensated for possible fluctuations or devaluations against the major global currencies
- The strength of a country's public finances is also a big determinant of debt costs. If Scottish borrowing and debt (as a share of GDP) were higher than UK borrowing, this would increase Scotland's relative borrowing costs.

Estimates made before the 2014 Scottish independence referendum suggested that the interest rates that would be charged to an independent Scottish government would exceed UK government rates by between 0.7 and 1.7 percentage points in the medium term[4] – that is, not accounting for any initial premium related to Scotland's lack of a track record. Since then, the gaps between the interest rates charged to different countries have fallen. This implies that the likely premium of Scottish debt costs over UK costs would now be between 0.4 and 0.9 percentage points, although there is no guarantee that a low interest rate spread environment will continue. The initial premium would be higher than this as Scotland built its track record.

Even a premium of 0.5 percentage points would make things more difficult for an independent Scotland. If debt were around 100% of GDP (the current UK level), it would mean spending 0.5% of GDP more each year on debt interest costs, which would require either spending less elsewhere or raising taxes. Half a percent of GDP is 5% of the annual budget for NHS Scotland or equal to the amount that would be raised by adding 2p to every rate of Scottish income tax.

To minimise its borrowing costs, the priority for an independent Scotland should be to show that its debt is a credible and attractive proposition to investors. Doing so would help to quickly reduce any 'new country' premium on its debt and minimise any borrowing premium relative to other countries. We identify three ways in which an independent Scotland could do this.

First, an independent Scotland would need to take difficult policy decisions to drive growth and deliver sustainable public finances. If Scotland could present a credible 'growth plan' – a strategy and set of policies that would help it grow more quickly than it would have done as part of the UK – this would make it a more attractive proposition for investors and improve its public finance position. Any gains would not be easy to deliver, however, and structural changes to the economy would require politically difficult short-term decisions, for example allowing some sectors to decline and people to lose their jobs, as Scotland specialises in other sectors. The Scottish government would also need to show that it could take difficult fiscal decisions, reducing a high deficit down towards 3% of GDP relatively quickly, to engender market confidence.

Second, an independent Scotland should ensure that it has strong and independent institutions to help it engage effectively with debt markets. It would require a well-resourced debt management office to make decisions around what type of debt to issue and to maintain relationships with key stakeholders. It should also ensure that the Scottish Fiscal Commission (the Scottish fiscal watchdog) is given new powers as a fiscal council so that the government's tax and spending plans are based on credible forecasts and can be subjected to independent scrutiny.

Third, one of the biggest sources of higher interest rates could be its currency choice if the option chosen is not viewed as credible. Getting this choice right – the topic of another Institute for Government paper[5] – is vital.

Introduction

As part of the UK, the Scottish government has very limited borrowing powers. The UK government instead handles external borrowing. In general, investors loan money to governments by buying government-issued bonds in return for an interest payment in each year of the debt contract – the length of the contract is called the 'maturity' – and the repayment of the principal amount at the end of the contract. In the UK, the Debt Management Office, an executive agency of the Treasury, issues bonds of varying types and maturities. If Scotland were to become an independent country, it would take on this responsibility.

Even before the coronavirus pandemic, public spending for the benefit of Scottish taxpayers far exceeded the amount of tax raised from Scottish businesses, consumers and workers.[6] Because of this, a newly independent Scotland would have a substantial annual deficit that greatly surpassed the UK figure as a share of GDP, at least initially, unless it enacted very large spending cuts or tax rises. As a result, it would need to borrow large amounts from domestic and international investors immediately. Scotland's ability to borrow, and to do so at low rates, would be important for the newly independent government's capacity to support public services and for Scotland's fiscal sustainability.

An independent Scotland would be a small advanced economy, with a GDP per head similar to the UK. However, Scotland would need to take steps to ensure that its debt was a credible and attractive proposition for investors, including developing credible plans for the management of the economy and public finances in the medium term. The higher Scotland's borrowing costs were, the more difficult its fiscal position would be. As we discuss below, Scotland would face limits on how much it could borrow year after year. We estimate that the interest rate on Scottish bonds could be around 0.4–0.9 percentage points higher than that of UK bonds – even after Scotland had established its reputation with lenders. A premium of 0.5 percentage points would imply spending an extra 0.5% of GDP on debt interest each year by the middle of the century.[*] That would mean less money for public services and benefit payments, unless taxes were raised. For context, 0.5% of GDP is around 5% of the NHS Scotland budget, or the amount raised by putting 2p on every rate of Scottish income tax.[7]

This paper looks at how – and at what cost – an independent Scotland would borrow, based on the experience of other advanced economies, including the UK. We first ask how much Scotland would be able to borrow consistently each year, and what that implies about the scale of any fiscal consolidation that would be required, before exploring what premium Scotland's debt would face over UK debt. Some factors that are beyond Scottish policy makers' control would affect this premium, but factors

* Based on simulations of debt as a share of GDP, assuming that total borrowing is equal to 3% of GDP, Scotland takes on a population share of UK debt and interest rates evolve according to the Office for Budget Responsibility's projections in its 2020 Fiscal Sustainability Report; Office for Budget Responsibility, *Fiscal Sustainability Report: July 2020*.

that Scotland's politicians would have control over, including its fiscal position and currency choices, would also influence it. We explore how Scotland could ensure it is able to borrow at the lowest possible cost, including the practical steps it would need to take (principally setting up an effective debt management office) and the broader policies it should adopt to build credibility with international credit markets.

This paper is based on analysis of data on debt, deficits and the cost of borrowing across advanced economies, a review of the relevant literature, and interviews with experts in the field.

How much could Scotland borrow?

Under current devolution arrangements, Scotland does not borrow from international capital markets. It has only a very limited capacity to borrow temporarily (through the National Loans Fund) in special circumstances or if spending unexpectedly exceeds revenues.[8] The Scottish government's spending cannot therefore consistently exceed the revenues it receives through a combination of devolved taxes (approximately 31% of revenues) and grants from the UK government (approximately 69% of revenues).[9]

How much would an independent Scotland need to borrow?

We can calculate how much Scotland would need to borrow each year if public spending in Scotland and the tax revenues derived from economic activity in Scotland remained unchanged but there was no grant from the rest of the UK to Scotland. In 2019/20 – before any fiscal impact of the coronavirus pandemic – the deficit in Scotland would have been 8.6% of GDP.[10] This is much higher than the 2.6% of GDP that the whole UK borrowed in that year. A recent Institute for Government report shows that this is because spending per head on public services is higher in Scotland, while revenues per head are about average. Scotland's fiscal position in 2019/20 was not an anomaly. The implicit Scottish deficit has been at a similar or higher level for several years.

If Scotland were to become independent, it would no longer be able to draw on the implicit cross-subsidy from the rest of the UK, that is, a grant from the UK government to the Scottish government that exceeds the revenues from Scottish taxpayers that flow in the other direction. But it would have the freedom to decide how to spend the money that the UK government currently spends on Scotland's behalf. Indeed, part of the case for independence is that an independent Scotland would make different choices about how to spend money and raise taxes currently controlled in Westminster. For example, the SNP has indicated that it would spend much less on defence than the 2% of GDP that the UK does.[11] Nonetheless, Scotland would likely begin with a substantial deficit. Any difference between spending and revenues would need to be met by borrowing – issuing debt for investors to purchase.

The deficit that an independent Scotland could afford to run consistently would depend on how much it would be able to borrow consistently from international debt markets. It is inconceivable that Scotland would be able to borrow as much as 8 or 9% of GDP consistently without facing significantly higher borrowing costs.

No country consistently borrows as much as Scotland's 2019/20 implicit deficit

During the coronavirus pandemic, many countries have borrowed much more than 8% of GDP – and done so at record low interest rates. In 2020/21, the UK deficit was 14.5% of GDP, the highest in its peacetime history.[12] This shows that countries can sometimes borrow much more than Scotland's implicit deficit of 8% and find willing investors who are confident that the money will be repaid.

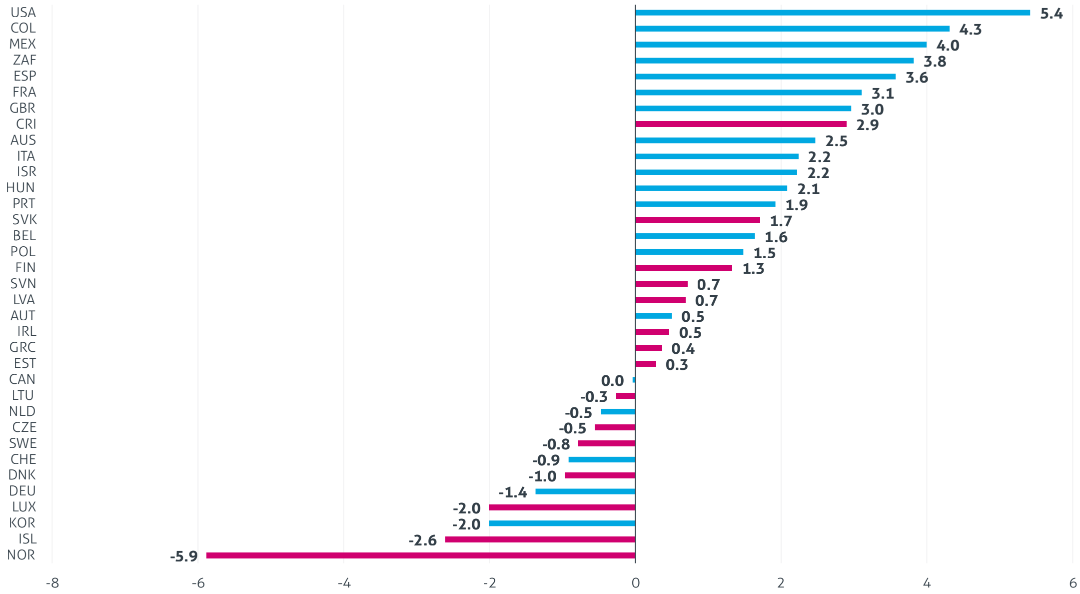
However, 2020/21 is a special case. The need to put large swathes of the economy into hibernation is unprecedented. Many countries – including the UK – have also been able to rely on their central banks' quantitative easing programmes, which have had the effect of keeping government borrowing costs low.[13] The increase in bonds that the Bank of England purchased through quantitative easing closely matches the total increase in government borrowing, which means that the bank has, in effect, absorbed most of the additional supply of government bonds. This has also happened in other countries, and later in this paper we discuss how Scotland's currency choice would affect how much flexibility it would have to do this.

The UK has borrowed more than 8% of GDP in only three years since the Second World War – in the aftermath of the financial crisis (2009/10 and 2010/11) and during the coronavirus pandemic (2020/21) – and it is forecast to do so again in 2021/22.[14] There is a big difference between the ease with which countries can finance temporary increases in borrowing during a crisis (even without quantitative easing) and consistently large deficits in normal times.

To understand how much Scotland might be able to borrow on a consistent basis, it is therefore informative to look at how much other advanced economies have been able to borrow consistently over the past 25 years. The fiscal position of other similar countries – for example, Ireland and Norway – could also have a direct impact on how much and how easily an independent Scotland could borrow. This is because some potential investors would weigh up whether to invest in Scottish debt or some other similar small, advanced country. If Scotland's fiscal position were substantially worse than its peers at a given point in time, it would be harder for Scotland to borrow. These peer effects partly explain why countries have been able to borrow to fund the coronavirus pandemic: most Western countries have been in a similar position.

Rather than focus on borrowing in one year, we look at five-year averages. Countries can maintain very high deficits for a short period but a five-year average gives a sense of how much they are borrowing consistently over several years. Figure 1 shows average annual borrowing for all OECD countries in the five years up to 2019. Over that period, the US had the highest average borrowing, at 5.4% of GDP. Among smaller countries (denoted in pink), none borrowed more than 3% of GDP each year on average. Any country with an average deficit of 8% would have stood out as a less attractive option for investors (all else equal).

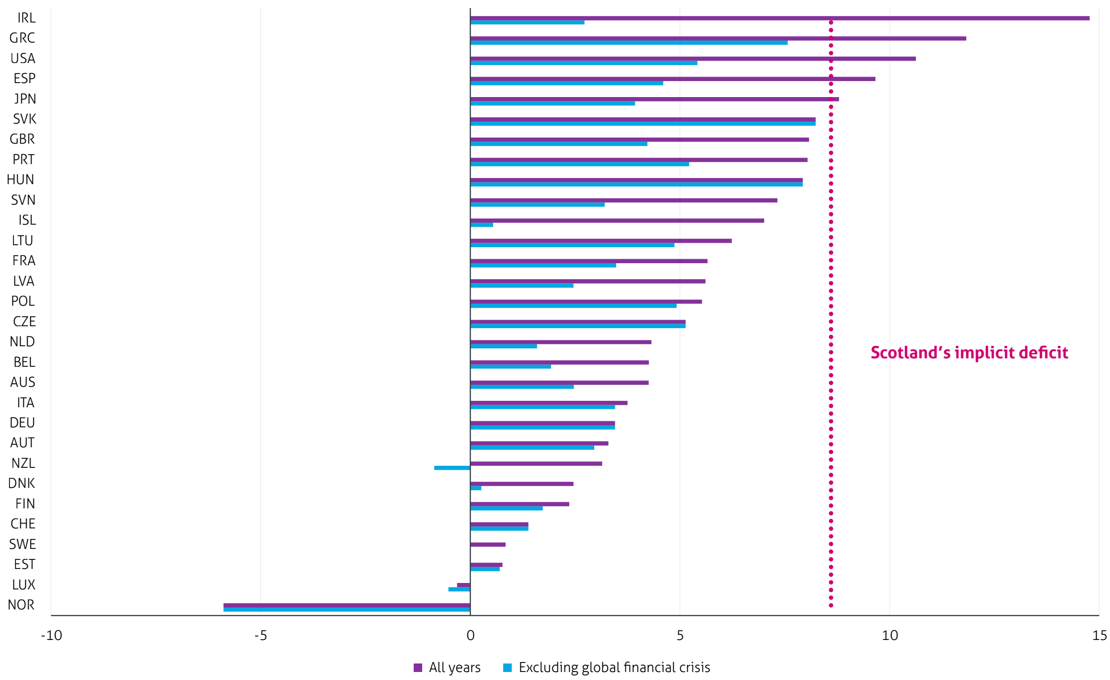
Figure 1 **Average annual deficit (% of GDP) of advanced economies, 2015–19**



Source: Institute for Government analysis of OECD, *General Government Deficit (Indicator)*, 2021; Scottish government, *Government Expenditure and Revenue Scotland*, 26 August 2020. Countries in pink are those with GDP below $500bn (adjusted on a purchasing power parity basis).

Figure 2 shows the highest average borrowing for each country over any five-year period between 1996 and 2019. Many of those countries have never had borrowing as high as Scotland’s implicit deficit over a five-year period. Those that have did so in the aftermath of the 2008 global financial crisis, when many other countries also had higher deficits. The figure also shows the same calculation but excluding the years 2009–13. Outside of that crisis period, advanced economies have generally borrowed much less than 8% of GDP.

Figure 2 **Highest five-year average deficit (% of GDP) for select advanced economies since 1996, including and excluding the global financial crisis (2009–13)**



Source: Institute for Government analysis of OECD, *General Government Deficit (Indicator)*, 2021; Scottish government, *Government Expenditure and Revenue Scotland*, 26 August 2020.

Furthermore, small countries with their own currencies (for example, Denmark, New Zealand, Norway and Sweden) have tended to borrow low amounts, while large countries and those that have adopted the euro have been able to borrow more. Historically it has been difficult for small countries with their own currency to borrow large amounts, in part because countries in currency unions can rely on an implicit expectation that they will be bailed out to protect the union. Thus, Scotland's fiscal policy would need to be even more restrained if it adopted its own currency.[15]

How much Scotland can borrow would also depend on its legacy debt obligations

A country's ability to borrow will depend not only on the amount it is trying to borrow that year. It will also depend on the total stock of debt that government has and the interest payments that must be made on that debt each year. When judging whether or not to loan money to a country, and at what cost, investors look at the likelihood that a country will default – that is, fail to repay the debt and interest. From the perspective of an investor, the risk that a country will default is much higher if it is already devoting a significant share of GDP to servicing other debt than if it is debt free.

Scotland currently has no debt. All debt that the UK government has issued so far will continue to be the contractual responsibility of the UK government.[16] If, at the point of independence, Scotland were to take on none of the UK's existing stock of debt then, all else equal, it would be in a better position to borrow from the markets than if it had a significant initial debt stock. The Sustainable Growth Commission – which was established by the first minister and SNP leader, Nicola Sturgeon, to assess projections for Scotland's economy and public finances under independence – stated in its 2018 report that: "By definition, an independent Scotland will start with zero debt. The strength of that position should not be underestimated."[17]

However, the Sustainable Growth Commission also acknowledged that Scotland would intend to agree an annual payment to the rest of the UK to cover a portion of UK debt servicing costs – likely based on a population share.[18] Technically, this might not show up in statistics as 'Scottish debt'. But the practical impact of this obligation would be the same: a requirement to make annual payments to satisfy debt contracts. The fact that the payment would go via the UK government, rather than directly to the investor, is not important from the perspective of a prospective investor.

Any agreement on the allocation of legacy UK debt would be the subject of negotiations with the rest of the UK at separation. Some commentators have suggested that Scotland could refuse to pay any portion of UK debt, on the grounds that it is the UK government's obligation and that Scotland has previously paid a lot into the exchequer through North Sea oil revenues.[19] While this approach would be legally possible, it could be counterproductive if it were arrived at acrimoniously. A straight refusal by the Scottish government to negotiate with the UK government could be viewed as a form of default.* At the very least, it would probably not give investors confidence that the new Scottish government would be a trustworthy player that would abide by its debt obligations.

Scotland accounts for approximately 8% of the UK population and 8% of GDP. An agreement based on Scotland's population share would imply a burden equivalent to a debt stock of 95% of GDP in 2024/25.** This would be a relatively high debt burden internationally. Mainstream economic opinion on the risks of sovereign debt has evolved over the past decade as circumstances have changed. Before the global financial crisis, most advanced economies had debt below 50% of GDP, and a debt level of 80%, 90% or 100% of GDP would mean a heightened risk that the country would default. However, in 2021, most advanced economies have debt levels at or around 80–100% of GDP and yet interest rates on government debt are at record lows, with no sign that markets are taking fright.

An influential paper by Olivier Blanchard, the former head of research at the International Monetary Fund and president of the American Economic Association, in 2019[20] argued that, when economy-wide growth rates are higher than government interest rates, small increases in borrowing can be financed without future tax rises or spending cuts as economic growth will outpace the burden of repayments. Interest rates are currently below growth rates. But there is no guarantee that this will always be the case. The Office for Budget Responsibility has found that, historically, the UK interest rate has had long periods both above and below the growth rate.[21] Furthermore, as Blanchard acknowledges, this logic does not apply to big increases in borrowing because debt servicing costs will take up more public spending over time.[22]

* The UK government could also refuse to pass the enabling legislation to implement independence in such a stand-off.

** Institute for Government calculations using Office for Budget Responsibility, 'Public finances databank', May 2021, retrieved 18 May 2021, https://obr.uk/data

It is not sustainable for debt as a share of GDP to increase indefinitely

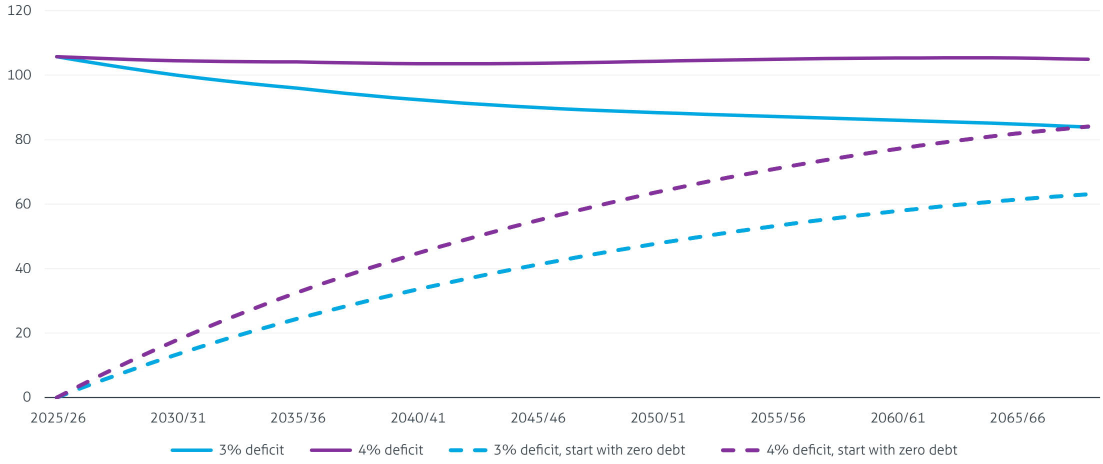
While the policy environment is undoubtedly different now to how it was 20 years ago, and countries may be able to live with higher debt than was previously the case, it does not change the underlying fact that there are some limits to how much debt governments can accumulate. These constraints would apply to an independent Scotland as they do to all governments.

If debt as a share of GDP increases consistently over time, eventually a country will reach a position where its public finances are unsustainable, since an ever-growing share of public spending would have to be devoted to debt interest payments. Experience of the past two decades shows that when crises come along, deficits will (rightly) increase to allow the government to respond to the shock and support the economy and citizens. Therefore, a sustainable public finance position should be one in which debt as a share of GDP is falling – even if only slowly – in 'normal times' outside of crises.[23]

Figure 3 shows a projected path for Scottish debt as a share of GDP. A deficit of 3% of GDP is consistent with the debt share falling slowly in normal times if Scotland were to inherit its population share of UK debt and to experience economic growth in line with the Office for Budget Responsibility's projection for the UK: around 2% a year. If Scotland were to grow more quickly, it might be able to borrow more. However, it will not be easy for Scotland to grow more quickly, and this certainly should not be assumed to happen automatically. If Scotland were to start with zero debt, the debt share would increase slowly initially, but would eventually level out below 70% of GDP if there were no crises.

If Scotland's deficit was 4% of GDP, debt would remain roughly constant as a share of GDP in normal times if Scotland inherited a population share of UK debt. Given that crises are likely over the next 50 years, this would mean debt would almost certainly be on an upward path and, eventually, would reach unsustainable levels.

Figure 3 **Independent Scotland debt with different deficits and starting debt positions, % of GDP**



Source: Institute for Government calculations using Office for Budget Responsibility, *Fiscal Sustainability Report: July 2020.* Based on projections for UK growth, assuming Scotland becomes independent in 2025/26 and takes on its population share of UK debt or no debt. 10 per cent of the debt stock is rolled over each year.

A sustained large deficit would be inconsistent with the Scottish government's ambition of joining the EU

Financial markets would not be the only constraint on Scotland's borrowing. The stated ambition of the Scottish government is to rejoin the EU.[24] But doing so with a large deficit would be difficult. EU members must sign up to the stability and growth pact, which requires a deficit of no more than 3% of GDP (and debt below 60% of GDP).[25] This is one of several requirements that an independent Scotland would need to satisfy.[26] In practice, a deficit below 3% is not a prerequisite of EU membership. Croatia joined the EU with a deficit of 5.2% in 2012, but only because that deficit was on a downwards trajectory and the EU immediately applied pressure to ensure the deficit fell further.[27] There is no precedent for a country joining the EU with a persistent and non-declining deficit above 3% of GDP, even though all countries – including France and Germany – have breached the rule at some point. At the very least, a deficit of that level is likely to make accession more complicated.

The UK government has ruled out a formal currency union with Scotland, but if such an arrangement were to proceed, that would also include fiscal rules to ensure the currency union remained stable. The latest set of UK government fiscal rules – abandoned when the pandemic hit – allowed for borrowing of around 3% of GDP at most in normal times.[28]

An independent Scotland would need to reduce borrowing to around 3% of GDP in normal times

If Scotland wanted to accede to the EU, it would need to reduce its deficit to 3% of GDP. This is also the level of borrowing that would be consistent with debt falling slowly as a share of GDP outside of crises and would be in line with what other similar countries have tended to borrow. A level of borrowing above this would frustrate an independent Scotland's European ambitions and would leave the Scottish public finances vulnerable to shocks in future. For this reason, it would be harder and more costly to borrow from international debt markets.

Reducing borrowing to around 3% of GDP would require a consolidation of 5–6% of GDP over Scotland's pre-coronavirus implicit deficit of 8.6% of GDP. The Sustainable Growth Commission outlined how it would achieve some of this – including reducing defence spending and other spending that the UK government currently controls – but this amounted to only 1.2% of GDP[29] and would require a further consolidation of 4–5% of GDP to be achieved over several years.

This does not mean that Scottish borrowing could never exceed 3% of GDP. All countries will need to borrow more sometimes in response to crises. Furthermore, an independent Scotland would be able to borrow more initially, so long as it had a credible plan for reducing borrowing to these lower levels. It would have more flexibility to do so if it began independence with no debt, but that would only delay – rather than prevent – a necessary fiscal consolidation.

The Sustainable Growth Commission's report acknowledges that Scotland's deficit would need to be reduced. It targets reducing the deficit to below 3% of GDP within five to ten years of independence.[30] This would require difficult choices, even if the economy grows more quickly. However, as this section has shown, they would be important and necessary ones if Scotland were to retain the confidence of debt markets and join the EU. A consistent deficit at a much higher level would not be sustainable.

How expensive would it be for Scotland to borrow?

Once the question of how much Scotland could borrow has been addressed, the next question is how expensive it would be.

All countries must pay interest on the debt they issue. Some of the most important determinants of the rate of interest are entirely out of governments' control. Interest rates on government-issued debt (also known as the 'yield') are affected by returns on other assets and global economic conditions. In 2007, a 10-year UK government bond had an interest rate of 5.0%.[31] In 2019, it was just 0.9%, despite the UK's debt level as a share of GDP being more than twice what it was in 2007. In June 2021, it was only 0.7%. Interest rates have moved in a similar way for all advanced economies. Yields will also be affected by future expectations about growth, inflation, domestic interest rates and exchange rates. To allow us to abstract from some of these influences and instead focus on the impact of other factors (such as market size and fiscal sustainability) on borrowing costs, we limit our data analysis to eurozone countries. For these countries, investors' expectations about exchange rates, interest rates and inflation are the same.[*] Any differences between eurozone countries' borrowing costs must, therefore, be explained by other country-specific factors.

In 2019, the yield on Italian 10-year government bonds was 2.2 percentage points higher than on German 10-year government bonds. These differences matter. Paying a higher interest rate on borrowing means that more government spending needs to be devoted to financing debt rather than providing public services, social security or investment.

It is therefore important to understand what 'premium' – the additional cost of borrowing – would be charged to an independent Scotland over and above the interest rate charged to the UK government in a world where Scotland remains part of the UK. Whether global interest rates are high or low on average, Scotland is likely to pay a premium. This premium would affect the burden of debt-servicing costs in Scotland and how much fiscal flexibility the government would have.

In this section, we outline what the main determinants of Scotland's borrowing costs would be. We take each in turn, before concluding the section with overall estimates of how much more expensive it would be for Scotland to borrow.

* Being part of a currency union is also likely to reduce spreads in and of itself because it is in the interests of other members of the currency union to prevent another member defaulting. We discuss this below.

Structural factors mean that Scottish government borrowing costs would be somewhat higher than UK government borrowing costs

The UK has certain structural advantages that Scotland would not share, which mean that Scotland would likely pay more to borrow. These factors do not relate directly to the policy stance or economic strategy that an independent Scotland might adopt, but instead reflect what are likely to be long-standing differences between Scotland and the UK.

Small countries pay a liquidity premium

First, all else being equal, smaller countries tend to pay a small premium over larger ones. This is called a 'liquidity premium'.[32] The market for the debt of a smaller country is smaller, because there is less of the asset in circulation. For example, the UK currently has around £2 trillion of outstanding debt,[33] while an independent Scotland would have less than £200bn, assuming it took on a population-based share. If an investor is looking to sell an asset, it would be easier to find a buyer for the asset immediately if it has a bigger market than if it has a smaller one.

Estimates before the 2014 Scottish independence referendum placed the liquidity premium between 0.25 percentage points[*,34] and 0.6 percentage points.[35] Another way to estimate the size of the liquidity premium is to look at countries of different sizes that have otherwise similar risk profiles. For example, in 2019, Belgium and France had very similar debt-to-GDP ratios, but France (as a larger country) had a slightly lower yield (by 0.1 percentage points).

Scotland would pay a premium until it had established its credibility

A more important source of a premium, at least initially, is likely to be the lack of a Scottish track record.[36] One reason why the UK and other developed economies can borrow at cheap rates is that they have a long-standing reputation for paying their debts. The UK has never defaulted, for example. On the other hand, Scotland has no record of debt repayments. A new country – with a new set of untested institutions – would not be as attractive to investors as otherwise similar countries. As a result, some premium would be necessary to incentivise them to hold Scottish debt over other assets.

A new independent country is rare. A new independent country that is also an advanced economy is almost unprecedented. After the partition of Belgium from the Netherlands in the early 19th century, interest rates on their debt were 10–25% higher than pre-1830.[37] More recent potential comparisons – for example, the break-up of Czechoslovakia in 1993 – do not provide a helpful reference point given the many other political and geopolitical changes occurring at the same time.

* This is the difference between national rail bonds and UK government bonds – the government guarantees both of them, so the risk is the same, but the market size is different.

While the lack of recent precedent makes it difficult to estimate, interviewees were nonetheless confident that a substantial new country premium would apply initially. Unlike the small-country premium, this would not be permanent. If Scotland can show that its institutions are robust, that its economy has good growth potential and that its politicians are able to make difficult decisions – where necessary – to ensure investors are paid, the premium should fall over time. Later in this paper we discuss ways in which an independent Scotland could ensure that the new country premium falls more quickly.

Volatile tax revenues could also cause concern to investors

A third source of a possible premium for Scotland is the volatility of its tax revenues, that is, the extent to which government revenues fluctuate over the economic cycle. Countries with more volatile tax bases might be more at risk of default – recessions and crises will mean bigger falls in revenue and therefore higher deficits. This is especially problematic if countries are inclined to spend more of their buoyant tax revenues during booms, rather than saving. In 2014, total tax revenues generated in Scotland (including those that devolved and centralised taxes currently raise) disproportionately depended on two sectors, North Sea oil and financial services, both of which have experienced high peaks and low troughs. Analyses before the 2014 Scottish independence referendum identified this as a likely further small source of a premium for Scotland, estimated at the time to be around 0.1 percentage points.[38]

However, this analysis is no longer clear cut. The oil price has fallen further since 2014, and now oil revenues account for only 2% of revenues in Scotland.[39] This has weakened Scotland's fiscal position (a different source of a potential premium, discussed below), but also reduced the volatility of its revenues. While finance remains a big industry in Scotland, it is unclear whether this would still be true after independence. If some banks chose to leave Scotland, and took activity and jobs with them, the tax base would be less volatile (although the tax take may fall as a result). More generally, an independent Scotland would aim to chart its own path and develop its own economic model, which might look quite different from its economy as part of the UK. The volatility of a future independent Scotland's tax base would depend on the path it takes, and so this is an uncertain source of any bond premium.

Scotland's currency choices would affect how expensive it is to borrow

An independent Scotland would have only limited control over the sources of a premium identified in the previous subsection. But other choices that an independent Scotland would have to make would affect the premium too – perhaps the single biggest economic choice being about its currency arrangements. The implications of different currency choices for Scotland are discussed in detail in another Institute for Government paper.[40] Here, we focus on the implications for borrowing.

Broadly, there are four types of currency regime. Scotland could:

- adopt a new currency and allow it to float freely
- adopt a new currency and peg it to another (for example, the pound or euro)
- enter into a formal currency union with the UK or eurozone
- informally adopt another currency, such as the pound or euro.

Each would have its own implications for borrowing costs.

Scotland would pay a premium for issuing debt denominated in a new currency

Debt denominated in a new Scottish currency would attract a premium relative to UK debt denominated in pounds sterling.

A free-floating currency would raise the risk of exchange-rate volatility. A (possibly international) investor would be entering into a contract denominated in Scottish pounds. However, there is a risk that the exchange rate could change over time, changing the value of this contract in US dollars or pounds sterling. Any appreciation of the Scottish pound would benefit the investor, as the contract would be worth more in foreign currencies, while a depreciation would have the opposite effect. However, investors will generally need to be compensated for additional uncertainty, hence a premium associated with exchange-rate volatility. There are few examples of small advanced economies with entirely free-floating currencies, but the risk of volatility for a small country's currency would be high. This would be especially true as the country was establishing itself.

The alternative to a free float is a peg. Pegging the exchange rate would reduce the chance of the exchange rate changing and so, in principle, reduce the uncertainty premium that investors would charge. However, if markets judged the chosen peg to be unsustainable, investors would require a substantial premium. This is because the value of the contract would fall by the scale of the depreciation should the peg not be maintained.

Even if Scotland adopted its own currency, it could choose to issue debt in another currency, for example GB pounds. This would have the effect of removing exchange-rate risk from investors. If the Scottish currency were to depreciate, the investor would not be affected because the contract is denominated in another currency. However, the risk would fall on the Scottish government instead – a depreciation would mean that debt repayments were much more expensive and would take up a greater share of tax revenues. This is also a risk for investors, because a country is more likely to default if its debt interest payments become unaffordable. Borrowing in another currency is a phenomenon known as 'original sin', and the heightened risk of default means that there is a premium associated with this debt.[41]

Borrowing premiums would be lower in a formal currency union – but that is not a decision Scotland can make alone

A formal currency union – with either the UK or the eurozone – is another option that has been mooted. Unlike a peg, Scotland could not enter this unilaterally as it would require agreement from other members of the union. The advantages over a peg are that the arrangement is more long term and credible and monetary policy should be made (at least in principle) with Scottish input and with Scotland's economic interests in mind. Furthermore, the discipline imposed within a currency union, and the incentive all members have to ensure other members do not default, mean that currency unions tend to reduce default risk premiums. However, in 2014 the Treasury advised that the UK should not agree to a currency union with Scotland if Scotland voted for independence, and Scotland would not, at least initially, be able to join the eurozone.[42]

Borrowing premiums might also be lower in an informal currency union

The currency option favoured in the Sustainable Growth Commission's report in 2018 was for Scotland to continue using the pound but without being in a formal currency union with the rest of the UK. This option is usually referred to as 'sterlingisation'.[43] There is some precedent for this kind of approach: Montenegro informally uses the euro and does not face any penalty from ratings agencies for issuing debt in euros. However, the Sustainable Growth Commission's report states that, in the long term, Scotland would look to adopt its own currency. The premium that Scotland would face would therefore likely depend on how the debt contracts are worded. If the currency of the contract changes when Scotland's currency changes, the depreciation risk identified above for a pegged currency remains (although it would likely not affect shorter contracts that were due to mature while Scotland still used the GB pound). If, however, the debt contracts are denominated in pounds, this would then become foreign-denominated debt when Scotland adopted its own currency – introducing the same default risk as described above.

Currency choice would also affect the ability of Scotland's monetary authority to engage in quantitative easing

Currency choices would also affect what freedom Scotland would have over monetary policy, which could matter for borrowing.

Under sterlingisation, Scotland would not be able to print money. It could not, therefore, do its own version of quantitative easing during a major crisis. This has been an important feature of the UK's economic response to the coronavirus pandemic as the Bank of England has increased its debt purchases. As noted above, a by-product of the bank's intervention has been to increase demand for UK debt and so allow the government to finance new debt at very low rates. Were Scotland in a formal currency union (such as the eurozone or a new sterling union), the central bank would include Scottish assets as part of its bond purchasing programme. But this would be unlikely to happen under sterlingisation.

The central bank would also be constrained in its ability to act if the exchange rate were pegged. With a peg, monetary policy is required to maintain the peg by using interest rates to regulate demand for the domestic currency. The head of the central bank in Denmark, which pegs its currency to the euro, concluded that quantitative easing was not an effective option given the country's currency regime.[44] Lowering borrowing costs is also not the primary objective of quantitative easing, and the independence of central banks means that the impact on government public finances is not something that will generally be taken into account when the policy is set.

Most interviewees thought that the freedom to use quantitative easing should not be a priority for Scotland's currency choice as it would be unlikely to be a lever that is required frequently. The coronavirus pandemic has been an exceptional event, and even countries that have not launched large quantitative easing programmes have still been able to borrow large amounts at relatively low interest rates. For example, Denmark's deficit was 23% of GDP in 2020, its central bank did not engage in quantitative easing and its yields now are similar to those in eurozone countries where quantitative easing has expanded. Although some advocates of modern monetary theory argue that monetary financing could be a way to fund the government in the longer term, ultimately the government's budget constraint still applies and this would not be a 'free lunch' allowing for higher deficits without consequence.[45]

No currency option is entirely without challenges from the perspective of bond markets. However, there are several options that probably would be sustainable. All else equal, a formal currency union is likely to attract the smallest currency-related borrowing premium. If it is credible, an informal currency union (sterlingisation) could have a similar effect. If Scotland adopts its own currency, the premium associated with a pegged currency (if it were viewed as credible) would be lower than if the currency were allowed to float freely, as the fluctuations of a small currency would require a substantial compensating premium. However, a non-credible peg and an anticipated devaluation would result in the highest currency-related premium among all of the options.

The most important determinant of borrowing rates is sustainable public finances

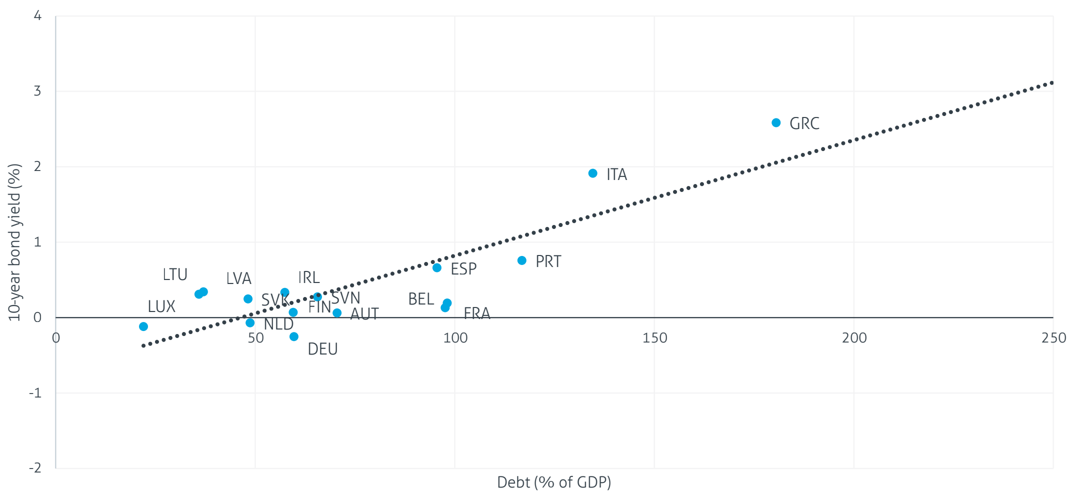
The European Commission defines fiscal sustainability as "the ability of a government to sustain its current spending, tax and other policies in the long run without threatening the government's solvency or without defaulting on some of the government's liabilities or promised expenditures".[46] If investors are worried that a country may not be able to honour the debt contract they are signing, they will require a 'risk premium' – a higher interest rate to compensate for the risk that they will lose their money.

There is no single measure that fully captures whether a government's finances are sustainable. An evaluation of sustainability will depend on the size of the debt stock relative to GDP, but also how expensive it is to finance that debt (debt interest payments) and how quickly that debt is being added to (the deficit). As our analysis above shows, in the early years of independence, Scotland would likely have a high deficit and relatively high debt as a share of GDP if UK debt is shared on a population basis. A country's fiscal sustainability also depends on growth prospects – a country will be able to finance debt more easily if the economy is growing quickly because tax revenues grow alongside the economy – and the perceived robustness of institutions to make difficult decisions to ensure debts can be honoured.

Although all these factors matter, investors commonly use the size of debt and deficits as shares of GDP as proxies for fiscal sustainability, and historically there has been a clear relationship between debt and the level of government interest rates. Figures 4 and 5 compare the long-term bond yields and debt-to-GDP ratios of all eurozone countries. They show that, in general, countries with higher debt and higher deficits pay more to borrow, but that debt levels are more predictive than annual deficit levels. Debt reflects a longer-term fiscal position, while the deficit can move around from year to year. Ratings agencies also use these main metrics when determining what credit rating to give to different bonds.

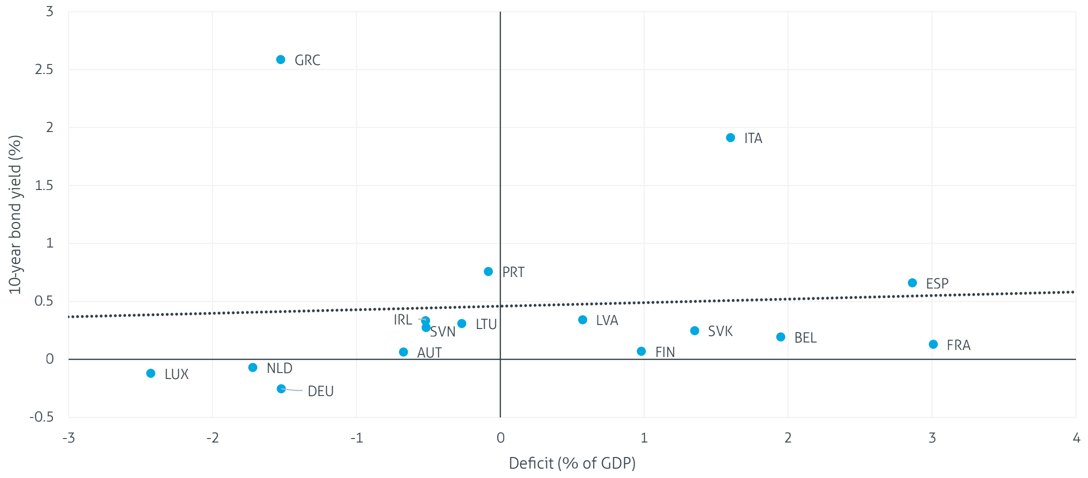
Academic evidence suggests that the relationship is, at least to some extent, causal, with studies on advanced economies finding a positive relationship between debt levels as a share of GDP and yields.[47,48] Debt is not only a measure of how difficult it might be for a government to repay future debt but could also act as a signal that a country has struggled to reduce high deficits in the past, that it has poor growth prospects or that it has been vulnerable to big shocks in the past. Debt levels and deficits thus partially explain the difference between countries' interest rates – that is, borrowing spreads.

Figure 4 **Relationship between debt (% of GDP) and 10-year bond yield in 2019, eurozone countries**



Source: Institute for Government analysis of OECD, *Long-term Interest Rates (Indicator)*, 2021; Eurostat, *General Government Gross Debt – Annual Data*, 2 April 2021.

Figure 5 **Relationship between deficit (% of GDP) and 10-year bond yield in 2019, eurozone countries**



Source: Institute for Government analysis of OECD, *Long-term Interest Rates (Indicator)*, 2021; OECD, *General Government Deficit (Indicator)*, 2021.

The relationship between debt and yields has changed over time. In 2013, for example, an extra 50 percentage points of debt as a share of GDP was associated with a 2 percentage point increase in yields. In 2019, a lower interest rate environment, a 50 percentage point increase was associated with only a 0.6 percentage point increase in yields. In 2021, yields are even lower, and even countries like Greece can borrow at low rates. However, these variables still matter, and will continue to do so in future, even if the precise size of the effect on yields changes over time.

There is good reason to think that considerations on the sustainability of public finances would be particularly important in Scotland's case. Before the 2014 Scottish independence referendum, various rating agencies and market analysts noted that Scotland's public finances would weigh negatively when rating the country compared with the current UK. This would be likely to be a problem even if Scotland were to start with no debt if its deficit were high, because it would have no track record in demonstrating its ability to reduce its deficit and repay its obligations. As noted above, it would be difficult for Scotland to borrow more than 3% of GDP each year consistently.

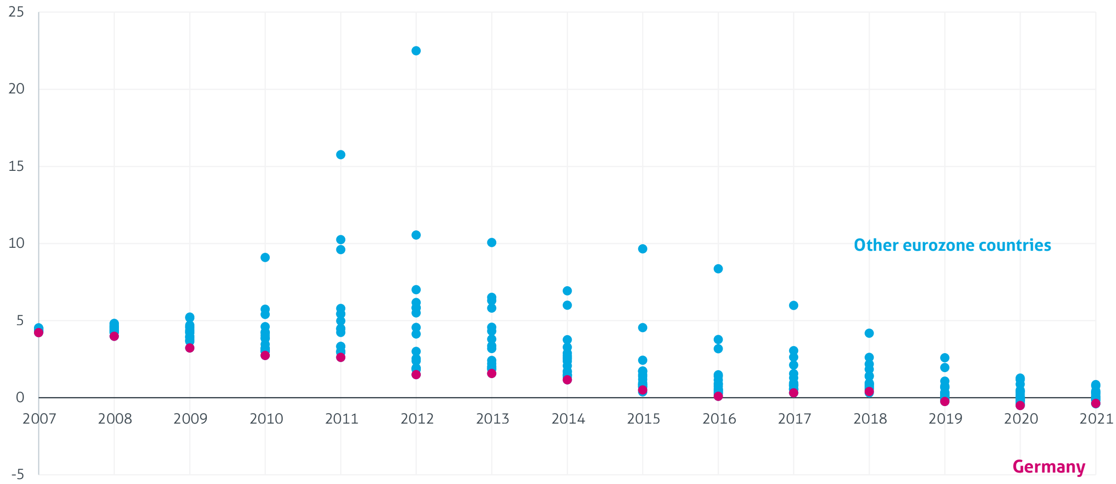
Scotland would need to show a commitment to sound public finances to reassure investors that its borrowing was sustainable. However, one should also be wary of focusing only on these fiscal aggregates when measuring fiscal sustainability. Other characteristics can have an impact on how sustainable or not a country's debt and borrowing levels are and thus the borrowing premium they face – for instance, weak growth prospects and weak institutions tend to exacerbate the impact of deficits on interest rates.[49] Healthier fiscal aggregates will be important, but should not be pursued at the expense of economic growth or instead of ensuring institutions are credible.

How high would Scotland's borrowing premium be?

Before the 2014 Scottish independence referendum, various estimates were published of the premium of Scottish borrowing costs over UK borrowing costs, accounting for many of the factors outlined in this section. All of these estimates assumed that Scotland would take – approximately – a population share of existing UK debt. The most rigorous study, conducted by the National Centre for Social and Economic Research, estimated that the premium would be somewhere between 0.7 percentage points and 1.7 percentage points over the UK for 10-year bonds.[50] Reaching a similar conclusion, Citibank estimated that in the long term the premium over the UK would be around 1.25 percentage points.[51] BlackRock and Moody's broadly agreed before the 2014 referendum that Scotland was likely to be rated several notches lower than the UK, implying a premium of a similar magnitude.[52] These studies all estimated the likely *medium-term* premium, that is, how much more expensive it would be for Scotland to borrow even after it had established a track record with investors as an independent country.

Since those analyses were carried out in 2013, the global interest rate environment has changed. The average level of government interest rates has fallen, and so has the spread between them (Figure 6 shows this for eurozone countries). In the period from 2007 to 2014, the spread between the borrowing costs of Germany and other eurozone countries – excluding the two countries that had very high-risk premiums at that time[*] – averaged 1.3 percentage points. Between 2017 and 2020, they averaged only 0.7 percentage points. Assuming that the hypothetical spread between UK and Scottish borrowing would have fallen by a similar amount, this suggests that spreads between UK and Scotland borrowing costs would be 0.4–0.9 percentage points in the current interest rate environment.

Figure 6 **Interest rate on 10-year government bonds, eurozone countries (%)**



Source: Institute for Government analysis of OECD, *Long-term Interest Rates (Indicator)*, 2021.

* These are Greece and Portugal. We exclude them from this calculation because a fall in their interest rates reflects a lower concern about default risk for these countries as well as broader debt market trends.

There is no guarantee that the current low interest rate (and low interest rate spread) environment will persist for ever. Government interest rates could remain much lower than historical norms or they could increase worldwide. If a higher-spread environment were to return, we would expect that the medium-term spread for Scotland over the UK would rise again to something more like the 0.7–1.7 percentage points estimated before the 2014 referendum.

Even a relatively modest premium of around 0.5 percentage points would make an independent Scotland's fiscal decisions more difficult. With debt at around 100% of GDP (as it would be if Scotland were to take on its population share of UK debt), this would imply spending an extra 0.5% of GDP on debt interest each year. We have established that there would be limits on how much Scotland would be able to borrow, so more spending on debt interest would mean less spending elsewhere and/or tax increases. There are many different ways that Scotland could bridge this gap, but to give a sense of the magnitude, 0.5% of GDP is 5% of the NHS Scotland budget[53] and the revenue that would be raised by adding 2p to every rate of Scottish income tax.[54]

These estimates apply to the premium in the medium term, assuming a credible currency arrangement. The 'new country' premium that would apply due to Scotland's lack of a track record would increase the premium above these medium-term estimates in the short term, while a non-credible currency choice could push the estimate higher still.

Some of the premium outlined in this section – such as the liquidity premium associated with smaller countries – would persist regardless of what actions an independent Scotland took. However, other elements would be under the Scottish government's control. Building sustainable public finances would help to reduce any medium-term risk premium over the UK. Demonstrating Scotland's credibility as a country that pays its debts would be critical to ensuring that any 'new country' premium fell quickly. In the remainder of this paper, we discuss how an independent Scotland could ensure it was able to raise finance successfully and at the lowest possible cost.

How would Scotland issue debt?

So far we have treated the actual issuance of debt as a trivial process, where underlying factors determine the price. The analysis in the previous section, for example, focused on 10-year government bonds. This is an effective way to compare the cost of debt for different countries but in practice governments issue a varied portfolio of debt, including shorter and longer maturities and index-linked bonds that protect investors from inflation risk. The choice of which debt to issue – and when – also affects how easily an independent Scotland would be able to finance its debt and how expensive it would be to finance.

This section sets out how an independent Scotland should manage its debt issuance.

Scotland would need to set up its own debt management office

Politicians should not be the main decision makers when it comes to debt issuance. The matters at hand are technical rather than political, and so should be treated as such. Currently almost all countries issue debt via a debt management office, a group of experts who decide which debt to issue and run auctions to sell the debt. Having an independent organisation in charge of these matters is internationally regarded as the most suitable set-up. The alternative, to make debt management the responsibility of the central bank, can lead to a conflict of interest. For instance, if the same institution that is responsible for setting the base interest rate that determines the cost of banks' borrowing and filters through into economy-wide interest rates is also responsible for government borrowing, this could lead to using monetary policy to try to reduce the cost of government borrowing, even where this comes at the expense of prioritising macroeconomic stabilisation.

An effective debt management office assesses the demand for different types of debt and maintains relationships with stakeholders to determine the best mix of debt to sell on the market. By deciding how to issue the most suitable combination of debt, the institution can help balance trade-offs. Having a debt management office can also boost a country's reputation with investors. To attract investors, Scotland would want to resemble other developed economies with which it would compete in the bond market. Emulating sound institutional frameworks would help with this. In particular, Scotland could learn lessons from the UK's Debt Management Office. This institution is well regarded internationally; it maintains a good relationship with the Treasury but has the power and adequate resources to make independent decisions.

Setting up an effective debt management office would require some spending but the costs need not be very high. The UK Debt Management Office, for instance, spends only around £20 million a year.[55] But the challenge of setting up such an organisation is not purely financial. Interviewees emphasised the importance of having good people to lead and work on this and other organisations. One suggested that Scottish institutions should be willing to pay a premium on talent to attract people who might be working outside of the country.

The new debt management office would need to choose how it issues debt

The new Scottish debt management office would be likely to need to take a different approach from the UK, at least initially; for example, in terms of what debt contracts it would issue, how long those contracts would last, and what currency they would be denominated in. The UK is unusual in issuing debt with a very long average maturity: the average maturity of UK debt is 15 years, which is much higher than that in most other advanced economies.[56]

The advantage of long-term debt issuance for the issuing country is certainty, and this is especially the case when it is possible to 'lock in' low interest rates for longer.[57] However, there is also more uncertainty for investors about the longer term, so the yield on longer-term debt tends to be higher. For example, the yield on a two-year UK bond is currently only 0.06%, whereas a 10-year yield is 0.8% and a 30-year yield is 1.3%.[58] The premium for longer-term debt is likely to be higher where there is political uncertainty, for example if a country is new. Furthermore, to the extent that Scotland faces a 'new country' premium initially, it would prefer to issue short-term debt rather than lock in those higher rates for longer.

As well as choices over maturity, the debt management office would face choices over which currency to issue debt in. This would depend in part on Scotland's currency choice but any country can choose to issue debt in a currency that is not its own, and many do. As we mentioned above, from an investor's perspective, the advantage of debt denominated in one of the world's major currencies (such as the pound, dollar or euro) is that the investor is insulated from the risk of currency depreciation, and so they will be willing to accept a lower yield. But if Scotland was not using this currency domestically, then the government would be exposed to currency risk: a devaluation of the Scottish currency against whichever currency the debt was issued in would make it more costly for the Scottish government to finance its debt. Because this would increase the risk of the Scottish government defaulting on the debt, any debt issued in a foreign currency would attract a risk premium.

A debt management office's decisions over issuance are mainly driven by the demand for different types of asset. If there is high underlying demand for a particular type of debt, it can be issued at lower cost. Longer-term debt is mostly demanded by domestic creditors, while international creditors tend to demand shorter-term debt. The share of debt that international creditors hold varies significantly. It is under 40% in Ireland and Finland, around 60% in the UK and more than 80% in Sweden, for example.[59] The reason why the UK can issue at long-term maturity relatively cheaply is that there is high demand for that debt.[*,60]

* This is because financial regulation in the UK means that pension funds demand holdings of very long maturity debt. The fact that defined benefit pension schemes have liabilities (that is, pensions to pay) that are linked to inflation also explains why the UK disproportionately issues inflation-adjusted (otherwise known as 'index-linked') debt.

Demand for long-term Scottish debt is likely to be low initially due to Scotland's lack of a track record and uncertainty over long-term economic prospects. As a result, Scotland would be likely to get a better price on shorter-term debt. Such debt is likely to be less risky to (domestic and international) investors, and therefore to attract a smaller premium. Over time, Scotland's capacity to issue longer-term debt would depend on which institutions demand that debt. If financial regulation remains similar, demand for long-term debt in Scotland could mirror that in the UK. However, if there is less domestic demand for Scottish debt (for example, if UK debt is viewed as a good – safer – substitute), a reliance on international creditors would likely mean that a shorter average maturity would be the most cost-effective approach.

A shorter average maturity is not necessarily a disadvantage. As interest rates have consistently undershot predictions since 2010, any country that has operated with shorter maturity debt,[61] and therefore refinanced more often at lower rates, will have reduced debt interest costs. But it would mean that Scotland's fiscal position was more exposed to changes in international interest rates.

The optimal strategy for issuing debt for Scotland would evolve over time, and would become clear only if Scotland became independent. However, it is likely to differ from the UK approach and making good decisions over the composition of debt in terms of currency and maturity would be important. A well-staffed debt management office based on the UK model is therefore the best way to ensure that Scotland manages its early issuances well and gets best value for money by issuing debt that matches demand.

How could an independent Scotland build its credibility with investors?

Any premium that Scotland would face over UK borrowing costs would depend on how attractive Scottish debt is to investors. That would depend on the broader economic outlook for Scotland and how credible the Scottish government's fiscal and economic policies are perceived to be.

Scotland might face a higher premium as a result of being a country with no track record. This means it would be especially important for Scotland to demonstrate its credibility by developing sensible medium-term plans and effective institutions. In this section, we set out what steps an independent Scotland could take to develop this credibility.

Good economic policies that boost growth would build market confidence

The Sustainable Growth Commission's report argues that becoming independent would allow Scotland to adopt policies that mean Scotland could grow more quickly than it would as part of the UK. It points out that many small, advanced economies have better economic performance than Scotland.[62] If it were possible to boost economic growth, this would also be attractive to investors. Countries that grow more quickly can more easily finance existing debt because higher economic growth brings higher tax revenues and fosters sustainable public finances. Countries that have defaulted have most often done so when economic performance is weak.[63]

Interviewees emphasised that investors do not just focus on the size of debt or a deficit. Countries that have good growth prospects will be more attractive propositions. Several interviewees mentioned that Scotland would be more attractive if it had a clear 'growth model'. This does not mean prescribing a particular approach – both Singapore and Sweden have what interviewees described as clear growth models, despite one operating with low government spending and the other with high government spending (although both have relatively low levels of government debt). Instead, this means that Scotland would need a 'clear story' it could tell for how it would grow, and which sectors it would specialise in. The Sustainable Growth Commission's report includes a focus on increasing migration as a route to higher economic growth, as well as emphasising the potential for Scottish renewable energy.[64] However, this is far from a comprehensive model for long-term growth.

Delivering policies that would boost growth in the medium term is one of the most important ways for an independent Scotland to demonstrate its credibility to investors. This is especially the case because policies that might boost growth in the medium term – including specialising in certain sectors – may be politically difficult in the short term. For example, diverting resources to one sector would mean other sectors declining, which would mean some people losing their jobs. Thus, delivering policies that might have a medium-term upside but with short-term costs would be a demonstration of the credibility of Scotland's growth plans and its politicians.

While buoyant growth should not be assumed from day one, good economic policies that increase Scotland's growth potential over time would make it a more attractive proposition for investors and delivering those policies would help to demonstrate its credibility. Faster economic growth would also help to offset the public finance impact of higher government interest rates. For example, if the premium were to be 0.5% of GDP, but Scotland's GDP were to increase by 1% relative to what it would have been within the UK, the additional revenue from higher GDP would cancel out the additional debt interest spending.

Scotland should have an independent monetary policy maker

Credibility can be shown not only by politicians taking difficult decisions, but also by taking some decisions out of politicians' hands. All advanced economies now defer monetary policy decision making (principally setting interest rates) to an independent central bank, with politicians setting the mandate but leaving the independent monetary policy makers to decide how best to achieve it. This has been effective at reducing inflation – something that investors care about because it means their investment retains more real value.

The precise role of monetary policy in an independent Scotland would depend on Scotland's currency arrangements. If Scotland were to (formally or informally) remain in a sterling currency union, monetary policy would be set in London and there might not be a central bank at all. Eurozone countries retain their own central banks, but the European Central Bank takes on most of their powers. However, if Scotland adopts its own currency – whether floating or pegged – the role of monetary policy would become important either to manage the macroeconomy and inflation or to maintain the peg respectively.

As with the debt management office, a good central bank would be dependent on the personnel that the bank could attract to lead and staff the organisation. Importantly, senior appointees would need to be able to show independence from the government and commitment to its mandate.

Scotland should adopt clear medium-term fiscal plans

As we noted above, there is a big difference between the amount of spending that is currently done for the benefit of Scottish citizens and the amount of taxes raised from economic activity in Scotland – with the deficit being more than 8% of GDP in 2019/20. A sustained deficit this large is the single biggest threat to Scotland's credibility with capital markets. The Sustainable Growth Commission argues that an independent Scotland could reduce spending on some UK-wide items that are currently decided in Westminster, for example on defence. However, this would still leave a substantial deficit of more than 6% of GDP and the Sustainable Growth Commission's report acknowledges the need to reduce this over five to ten years.[65]

Setting out a clear plan to reduce the deficit to more sustainable levels should be a priority to help reduce the borrowing premium. As with policies needed to deliver medium-term economic growth, this would entail some difficult political decisions in the short term. This does not necessarily mean that Scotland would need to embark on an austerity programme or implement immediate tax rises, especially if the economy needs supporting (and therefore immediate cuts would harm economic growth). However, investors are unlikely to be willing to lend to Scotland at low rates if it does not clearly set out how it intends to reduce the deficit and show a willingness to make the difficult political choices needed to do that.

One effective way for governments to show their fiscal intentions is through fiscal rules – self-imposed constraints on borrowing or debt that politicians' plans must conform to. In practice, fiscal rules in the UK have a chequered history and most of the 15 rules that have been set since 1997 have been abandoned.[66] However, interviewees argued that they can be an important statement of intention and that it would be especially important for a new country to be transparent about its plans.

Over time, an independent Scotland would hope to grow more quickly than it otherwise would have as part of the UK, which would increase tax revenues and allow for more spending. However, as the Sustainable Growth Commission's report acknowledges, there are "no silver bullets"[67] for delivering higher economic growth. The UK government has been struggling with its own 'productivity puzzle' for more than a decade, and there has been no quick-fix intervention. Benefits would likely emerge over the course of decades rather than months or years.

As a result, an independent Scotland should not assume that, simply by virtue of its independence, it would grow more quickly. And it should not base its fiscal plans on optimistic growth projections. That would lead it to develop unrealistic fiscal plans that would be flattered by unrealistically buoyant growth forecasts for tax revenues. That might make fiscal consolidation – in the form of lower spending or tax increases – appear unnecessary but, if the economic growth did not emerge, Scotland would have a large deficit and would not have shown its credibility to investors. Thus, even if higher growth would ease fiscal constraints in the longer term, a medium-term plan based on consolidation would be required.

Scotland should bolster the role of the Scottish Fiscal Commission as a fiscal council

An effective way for an independent Scotland to show that its plans are based on reasonable projections for the economy would be to have a truly independent forecaster. In the past decade, many countries have adopted independent forecasters, or fiscal councils, with a broader role to assess the reasonableness of their government's fiscal position. The UK's Office for Budget Responsibility, set up in 2010, is a successful example.

The evidence suggests that fiscal councils are associated with more fiscal discipline, but only when they are credibly independent.[68] Fiscal councils establish their credibility not only by providing more reliable forecasts than government forecasters but also by offering greater transparency about the true fiscal costs of government decisions. For example, the Office for Budget Responsibility has provided transparent analysis of the impact of student loan reforms on the public finances. Investors would look at whether or not Scotland has a credibly independent fiscal council when deciding whether, and at what price, to invest in Scottish debt.

Scotland already has a fiscal council – the Scottish Fiscal Commission. An OECD review of the commission in 2019 noted that "despite operating in a highly politicised environment, the SFC has been successful in establishing constructive relationships with key stakeholders and has quickly developed a reputation for delivering independent and credible forecasts".[69] The role of the commission would need to expand if Scotland were to become independent, as the fiscal powers of the Scottish government would expand. The OECD review also identified some existing challenges for the commission, including that it did not always have access to necessary timely information and that Scottish economic statistics are not as good as they could be. Were Scotland to become independent, it would be important for the commission's resources to be expanded to allow it to take on this broader role and to expand its analysis to take a longer-term view of fiscal risks and fiscal sustainability, as the OECD has recommended. It would also be important to maintain its independence from the government. Further empowering the Scottish Fiscal Commission and ensuring it has the resources to succeed would be an important signal from the Scottish government to international markets and should help to develop better fiscal policy.

Conclusion

If Scotland were to become independent, it would be a small, advanced economy of a similar size to New Zealand and Finland, with a similar GDP per head to the UK. As such, it would be able to borrow from financial markets. Its initial challenge would be to reduce what is currently a very high implicit deficit – 8–9% of GDP. This is higher than the deficit that an independent country would be able to sustain year after year. An independent Scotland would need to reduce its borrowing to around 3% of GDP a year in 'normal times' (outside of crises). This is a level that is consistent with debt falling steadily as a share of GDP, is in line with what other similar countries have managed to borrow in the past, and would be a necessary condition for Scotland to join the EU. This would require a substantial fiscal consolidation of 5–6% of GDP over the medium term. The Sustainable Growth Commission proposed some savings – including by spending less on defence – but this amounts to only around 1.2% of GDP, leaving a further consolidation being required of 4–5% of GDP.[70]

Even with a lower deficit, an independent Scotland would likely have to borrow at rates that are somewhat more expensive than UK debt, partly by virtue of being a smaller country but also – at least initially – because it would be a new country with no track record and would therefore be viewed as a riskier prospect.

In the current low interest rate environment, we estimate that an independent Scotland would face a premium of 0.4–0.9 percentage points over UK borrowing in the medium term (after any 'new country' premium had disappeared). However, if the higher interest rate environment of the early 2010s were to return, the premium could be higher (at around 0.7–1.7 percentage points). A premium of 0.5 percentage points would imply spending an extra 0.5% of GDP on debt interest if debt were around 100% of GDP. This would mean less spending on public services or higher taxes.

These challenges are not insurmountable. Scotland could prosper as an independent country even with borrowing rates that are somewhat higher than the UK pays. Proponents of independence argue that, over time, Scotland could implement policies that would allow it to grow more quickly. Were that to happen, it would outweigh any impact of higher interest rates on the public finances as additional tax revenue would provide more fiscal leeway. However, such an increase in economic performance is not inevitable and should not be taken for granted.

As this paper has shown, the key for an independent Scotland would be to demonstrate economic credibility and competence to reduce any 'new country' premium and establish itself as an attractive investment alongside other small, advanced economies. There is no one approach that would demonstrate credibility, but this paper identifies three high priority areas.

First, Scotland would need to show effective management of the public finances. This includes communicating its intentions for reducing the deficit in the medium term, setting out a clear plan for how it will do this and delivering on that plan. This does not mean 'austerity' regardless of circumstances. Effective public finance management requires macroeconomic stabilisation when the situation dictates. However, it would necessitate some difficult tax and spending decisions in the medium term.

Second, Scotland would need to design, empower and resource effective institutions. This includes a debt management office, a central bank and a reformed Scottish Fiscal Commission. Giving these institutions independent mandates and finding good people to lead them and demonstrate their independence from the government would be one of the most effective ways to show that the new country is a serious and trustworthy one.

Third, an independent Scotland would need to ensure its currency choice – the topic of another Institute for Government paper[71] – is sustainable and credible. If the currency is not viewed as sustainable, investors would likely demand to be paid a substantial premium to purchase Scottish debt.

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