Policies for an independent Scotland? Putting the Independence White Paper in its fiscal context

IFS Briefing Note BN149

David Phillips
Gemma Tetlow

Policies for an independent Scotland?
Putting the independence White Paper in its fiscal context[1]

David Phillips and Gemma Tetlow

Institute for Fiscal Studies

ISBN: 978-1-909463-43-1

Executive Summary

Fiscal backdrop

- Using the Office for Budget Responsibility's (OBR's) latest forecasts for the UK's public finances and under the assumption that Scotland would inherit a population share of UK government debt, our calculations suggest that the net fiscal deficit in Scotland would be 5.5% of GDP in the first year of potential independence, 2016–17. This would be around 3% of GDP larger than that for the UK as a whole.
- Exactly how Scotland's public finances will look in 2016–17 and how they would evolve in the years immediately after potential independence is uncertain – not least because of uncertainty about the level of revenues that will be derived from oil and gas production and the outcome of negotiations over what share of existing UK debt an independent Scotland would inherit.
- However, if an independent Scotland wanted to achieve a sustainable medium- and long-term fiscal position, further tax increases and/or spending cuts would likely be needed after independence. It is against this fiscal backdrop that the policy proposals in the Scottish government's White Paper should be considered.

[1] The authors thank Stuart Adam, Rowena Crawford, Carl Emmerson and Paul Johnson for comments, help and advice. They also gratefully acknowledge funding from the Economic and Social Research Council (ESRC) through the Centre for the Microeconomic Analysis of Public Policy at IFS (grant reference ES/H021221/1). The ESRC is supporting a programme of work addressing issues around the future of Scotland. One of the strands focuses on supporting new work at current major ESRC investments before and potentially after the referendum.

Tax proposals

- The White Paper rightly identifies the UK tax system as overly complex and inefficient. The general aspirations outlined for the tax system of an independent Scotland – such as simplicity, transparency and equity – are admirable but also uncontroversial.
- The main revenue-raising measure is the intention to streamline tax reliefs and exemptions and reduce tax avoidance, although precise details on how this would be done are lacking. The Scottish government also plans to increase revenues by abolishing the transferable income tax allowance that will exist in the UK for some married couples from April 2015.
- The three main tax cuts mentioned are to air passenger duty, employer National Insurance and corporation tax. The immediate cost of cuts to these taxes could be partially offset by positive knock-on effects on economic activity – for example, an increase in air travel and companies moving profits to Scotland from other jurisdictions.
- However, the costs of these policies in the short run would be significant and (in the case of the cut to corporation tax) it is possible that the UK might respond by lowering its own corporate tax rate. Thus these policies carry risks.

Spending proposals

- The Scottish government proposes to spend around £400 million a year less on defence than will be spent on behalf of Scotland by the UK government in 2015–16. This would still leave Scotland with relatively high defence spending for a small rich country.
- The proposal to halt the roll-out of personal independence payments (the replacement for disability living allowance) is estimated to cost around £300 million per year. A more generous carer's allowance would cost around £60 million per year. The proposal to halt the roll-out of universal credit would be less costly, but will mean similar numbers of losers (those who would have gained under universal credit) and winners.
- Plans for a more generous single-tier pension and to retain the savings credit element of pension credit after 2016 cost little in the short term. But by the late 2030s, these policies are projected to cost £240 million per year in today's terms.

- If an independent Scotland were to retain the state pension 'triple lock', it could lead to the state pension increasing by more than both prices and earnings, but in a non-transparent way. OBR projections suggest that keeping the policy in the long term could be expected to cost Scotland close to £1.5 billion a year in today's terms by the 2060s.
- Delaying the increase of the state pension age from 66 to 67 due to take effect between 2026 and 2028 would increase spending on the state pension and other benefits by around £550 million per year in today's terms. Lower life expectancy does mean that Scots benefit from the state pension for fewer years, on average, than people in the rest of the UK, which may make such a delay seem attractive. But in the late 2020s and early 2030s, a slightly higher fraction of people in Scotland will be aged 66 (1.3%) than in the UK as a whole (1.2%), suggesting the policy may actually be somewhat more costly for Scotland.
- The biggest increase in spending is planned for childcare: £100 million per year in the short term, rising to an estimated £1.2 billion a year under longer-term aspirations. The main argument for this seems to be to help parents of young children enter the labour market and increase their working hours. The Scottish government's analysis of the policy includes scenarios that would entail substantially more women entering work than there are non-working mothers who are directly affected by the policy. The usefulness of such optimistic scenarios seems questionable and may lead to confusion about the likely effects of such a policy. Indeed, the evidence that childcare provision boosts parental employment is surprisingly limited and rather mixed.

More giveaways than takeaways

- The White Paper outlined specific tax-raising measures and spending cuts that would together save just under £500 million a year. On top of this, there is an aspiration to raise a further £235 million through, as yet unspecified, measures to remove tax exemptions and reduce tax avoidance.
- The spending increases and tax cuts described in the White Paper are more numerous and more valuable – costing around £1.2 billion a year in the short term and potentially considerably more in the longer term if full aspirations for childcare and pensions are met.

- Some of these policies may have dynamic behavioural effects that mean that they could partly pay for themselves. But, even taking this into account, the spending cuts and tax rises outlined would not be enough to pay for all of the proposed giveaways.
- Against a backdrop of fiscal deficits, it looks likely that implementing such a net giveaway would require bigger cuts to other public services or benefits, or increases to other taxes.

1. Introduction

The potential consequences of independence for taxation, public services and the welfare system in Scotland are a key battleground in the ongoing campaigning ahead of the independence referendum this September. In its White Paper, the Scottish government sets out a number of tax and spending changes that it argues would lead to a fairer and more economically successful Scotland.[2] In this briefing note, we discuss a number of the most significant policy changes suggested and place them in the context of the fiscal backdrop that an independent Scotland looks likely to inherit.

An independent Scotland looks likely to need to engage in additional fiscal consolidation during its first few years – that is, tax rises or spending cuts. On the basis of the Office for Budget Responsibility's (OBR's) latest forecasts, the scale of that fiscal consolidation is likely to need to be greater than that being planned by the UK if an independent Scotland wanted to achieve a fiscal position that was sustainable over the longer term.

The White Paper is much more specific about tax *cuts* and spending *increases* than the tax *increases* or spending *cuts* that would pay for these and that would be needed to get the budget deficit down.[3] This is not entirely surprising. A similar tendency to focus on the positive is also a feature of the current tax and spending debate between the UK's main political parties – with policies, pledges and aspirations to boost spending on childcare, housing benefit, school meals and social care, to cut inheritance tax and boost tax allowances all mooted– even

---

[2] Scottish Government, *Scotland's Future: Your Guide to an Independent Scotland*, 2013, http://www.scotreferendum.com/reports/scotlands-future-your-guide-to-an-independent-scotland/.

[3] Our initial assessment of the White Paper, published by the BBC, made the same point: http://www.bbc.co.uk/news/uk-scotland-25109390.

though a further four years of spending cuts are pencilled in for after the next general election. But, while the desire to offer a positive vision is understandable, it is also important that the trade-offs such pledges entail are recognised. Spending more and taxing less in some areas, at a time when Scotland is likely to face ongoing budget deficits, inevitably means even bigger cuts or bigger tax rises elsewhere.

Section 2 briefly summarises the medium-term fiscal position that might face an independent Scotland, based on the latest forecasts from the OBR and our own calculations.[4] Section 3 discusses the changes to tax policy proposed in the independence White Paper and Section 4 discusses the spending plans. In both of these sections, we describe, where possible, the likely financial costs or savings from the proposed policies and other important effects that the policies could have. Section 5 looks at the policies as a whole and assesses how the proposed 'savings' compare with the 'costs'. Section 6 concludes.

2. Scotland's medium-term fiscal position

A companion briefing note sets out in detail the medium-term outlook for the public finances of an independent Scotland.[5] That document also describes the sensitivity of this outlook to assumptions about future revenues from offshore oil and gas production and the fraction of accrued UK debt that an independent Scotland might have to service. In this section, we briefly summarise the conclusions of that analysis to set the backdrop for the following discussion of the policies described in the White Paper.

Using the OBR's latest forecasts for the UK's public finances and under the assumption that Scotland would inherit a population share of UK government debt, our calculations suggest that the net fiscal deficit in Scotland would be around 3% of GDP larger than that for the UK as a whole in the first year of potential independence, 2016–17. We estimate that the net fiscal deficit would stand at 5.5% of GDP. This would include a primary deficit of (that is, non-debt interest spending exceeding revenues by) 2.8% of GDP. This compares with forecasts for the UK of 2.4% and 0.5% of GDP respectively.

---

[4] For more detail, see D. Phillips and G. Tetlow, 'Taxation, government spending and the public finances of Scotland: updating the medium-term outlook', IFS Briefing Note BN148, 2014, http://www.ifs.org.uk/publications/7229.

[5] Phillips and Tetlow, ibid.

As our previous analysis has shown, if an independent Scotland wanted to achieve a sustainable medium- and long-term fiscal position, further tax increases and/or spending cuts would likely be needed after independence.[6] The exact size of the fiscal tightening required – and how quickly it might be needed – would, however, be sensitive to a number of factors. But it is against this backdrop that the policy commitments made in the independence White Paper must be considered.

3. Tax policy and the White Paper

The White Paper rightly identifies the UK tax system as overly complex and inefficient, and one where exemptions and differential tax treatments create unnecessary opportunities for tax avoidance. Similar conclusions were drawn in the IFS-led Mirrlees Review of the UK tax system.[7] The general aspirations for the tax system of an independent Scotland are also admirable – but uncontroversial. Goals such as simplicity, transparency and equity are frequently espoused by governments and opposition parties, but the real question is what specific changes an independent Scottish government would implement to make it more successful in achieving those goals than successive UK governments have been.

Not unreasonably, the White Paper postpones most such specifics, proposing 'a more significant review of the tax system in the early years of independence'. Radical reform should not be rushed. But the political and practical challenges that such a review would entail should not be underestimated and radical reform would create losers as well as winners.

The main revenue-raising measure in the White Paper is the target to raise £250 million a year by the end of the first parliament of an independent Scotland (in 2021) through streamlining tax reliefs and exemptions and reducing tax avoidance. One specific tax exemption is mentioned – the recently introduced 'employee shareholder' (or 'shares for rights') scheme, which allows companies to offer employees shares, up to £2,000 of which will be free from income tax and National Insurance contributions (NICs) and up to £50,000 of which will be free from capital gains tax, in exchange for reduced employment rights. This is a

[6] See M. Amior, R. Crawford and G. Tetlow, *Fiscal Sustainability of an Independent Scotland*, IFS Report R88, 2013, http://www.ifs.org.uk/publications/6952.

[7] J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *The Mirrlees Review: Tax by Design*, Oxford University Press for IFS, Oxford, 2013, http://www.ifs.org.uk/publications/5353.

poorly designed scheme that invites tax avoidance and is ripe for abolition. But the UK Treasury forecasts that this exemption will cost less than £150 million per year for the UK as a whole per year in 2017–18, which would imply a cost to Scotland of between £10 and £15 million per year.[8] Thus substantial further, as yet unspecified, measures would be needed to meet the £250 million target.

The second revenue-raising measure is the abolition of the transferable income tax allowance that some married couples will qualify for from April 2015. This measure will benefit the one-third of married couples where one partner pays basic-rate income tax and the other partner does not pay income tax, by up to £210 a year, by allowing them to transfer up to 10% of the non-taxpayer's personal allowance to the taxpayer. The White Paper is right to point out that this policy has some undesirable features, notably a 'cliff edge' where eligibility is lost when one partner becomes a higher-rate taxpayer, which means some people may be worse off after a pay rise that pushes them over the higher-rate threshold. And it does favour some married couples over others, and over unmarried people. But, of course, abolition of the transferable allowance would mean the one-third of married couples that will gain under it would pay more tax. Overall, the policy is expected to cost the UK Treasury around £935 million a year in 2018–19, which would imply a cost to Scotland of around £70–£80 million a year – which could be saved if it were abolished.

The White Paper also mentions three priorities for tax cuts: air passenger duty (APD), employer National Insurance and corporation tax. The White Paper is right to point out the economic benefits that all three of these would bring, though it does not mention the environmental downside to cutting air passenger duty. But the obvious drawback of tax cuts is the cost.

GERS estimates that APD raised £234 million in Scotland in 2012–13:[9] all else equal, reducing it by 50% (as is the stated immediate priority) would lose half that revenue, and abolishing it would lose all that revenue. However, following such a large tax cut, one would not necessarily expect all else to be equal. The

[8] HM Treasury, *Autumn Statement 2012 Policy Costings*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221551/as2012_policy_costings.pdf and HM Treasury, *Budget 2013: Policy Costings*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221895/budget2013_policy_costings.pdf.

[9] Table 3.3 of Scottish Government, *Government Expenditure and Revenue Scotland (2014)*, http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS/GERS2014xls.

lower price of air travel may boost both in-bound and out-bound travel. HM Treasury, for instance, assumes that a 1% cut in the price of air travel boosts the number of passengers flying economy by 0.6% and the number flying business or first class by 0.1%.[10] The additional trade and business may also boost other tax receipts. Together, these effects would partially fund the large reduction in APD rates.[11]

The Scottish government has said that it aims to reduce corporation tax rates to 3p below the UK rate, which would cost around £270 million, if the responsiveness of taxable profits to the corporate tax rate matched the UK Treasury's assumptions for the UK as a whole.[12] However, an independent Scotland would be a much smaller and more internationally open economy than the UK is – particularly because of what would become cross-border movements of goods and services, people and capital between Scotland and the rest of the UK. This would mean the responsiveness of corporate profits to the corporate tax rate is likely to be greater in an independent Scotland, meaning more of the direct costs of lower corporate tax rates are likely to be offset by behavioural response by companies. Indeed, this openness, particularly vis-à-vis the rest of the UK, means that optimal tax rates in an independent Scotland (and, to a lesser extent, the rest of the UK) would likely be lower than in a unified UK. But this represents a challenge as well as an opportunity, as tax competition between Scotland and the rest of the UK could leave both countries raising less revenue than if they cooperated to set rates that would be best for them collectively. Box 1 provides further details on how optimal tax policy may differ in an independent Scotland.

[10] HM Treasury, *Budget 2014: Policy Costings*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/295067/PU1638_policy_costings_bud_2014_with_correction_slip.pdf.

[11] Although, of course, other tax increases to offset the remaining revenue loss may have dynamic effects reducing trade and business.

[12] Calculation based on the Scottish share of corporation tax in 2012–13 from GERS and the Treasury's Budget 2014 costing of the 1p reduction in the main rate of corporation tax for the UK as a whole in 2015–16 (https://www.gov.uk/government/topical-events/budget-2014).

Box 1. Taxation for an independent Scotland[a]

The recent IFS-led Mirrlees Review of the tax system proposed a range of reforms for the UK that would allow the government to raise the same amount of revenue and achieve the same amount of redistribution much more efficiently than it does at present. For the most part, these would be sensible changes for an independent Scotland to introduce as well.[b]

However, there may be reasons that the tax system appropriate for an independent Scotland might differ from the tax system appropriate for the UK as a whole. Differences between Scotland and the UK as a whole mostly point towards lower optimal tax rates in Scotland. A less unequal income distribution means there is less need for redistribution via heavy income taxation; less congested roads mean less rationale for heavy motoring taxation; and greater openness to the rest of the world (including the rest of the UK) implies lower tax rates on mobile tax bases – such as corporate income and very high personal incomes.

But this hints at the key new challenge independence would bring: the potential for tax competition between Scotland and the rest of the UK. There would therefore be a premium on cooperation and coordination to minimise potentially inefficient tax competition – as well as to minimise compliance costs for firms that trade (or hire etc.) across the border. To the extent that there is some tax competition, raising revenues from taxes on mobile bases would become harder for both Scotland and (to a lesser extent) the UK. This would point to relying more on relatively immobile tax bases, especially property. But in recent years Scotland has been moving in the opposite direction, raising less of its revenue from property taxes by freezing council tax rates in cash terms.

It would be up to the voters and governments of an independent Scotland to decide whether to take advantage of independence to institute a root-and-branch reform of the complex and inefficient tax system they will inherit. There may be no particular reason to believe that many of the changes recommended in *Tax by Design* would be, politically, much easier to implement in an independent Scotland than in the UK as a whole. And in this regard, the failure of the Scottish government to introduce politically difficult but much-needed reforms where it has had autonomy – notably, the failure to revalue properties for council tax purposes – does not bode well. But the creation of a new state is surely the best opportunity that is ever likely to present itself for radical and rational tax reform, starting from first principles, which has the potential to unlock really significant economic benefits.

[a] For further details, see S. Adam, P. Johnson and B. Roantree, 'Taxing an independent Scotland', IFS Briefing Note BN141, 2013, http://www.ifs.org.uk/publications/6912.

[b] J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *The Mirrlees Review: Tax by Design*, Oxford University Press for IFS, Oxford, 2013, http://www.ifs.org.uk/publications/5353.

The Scottish government has estimated that a 3p cut in the corporation tax rate would boost economic output by 1.4% and employment by 1.1% after 20 years, although no estimate of how much this reduces the cost of the tax cuts is provided.[13] However, the UK government has estimated that in the long run, over half of the cost of corporate income tax cuts (from 28% to 20%) is paid for by

[13] Scottish Government, 'Devolving corporation tax in the Scotland Bill', 2011, http://www.scotland.gov.uk/Resource/Doc/919/0120770.pdf.

higher output.[14] Profit shifting into the country in response to lower tax rates is not accounted for and would presumably pay for more of the tax cut. A paper examining the revenue effects of cutting corporation tax in Northern Ireland, which does include profit shifting, finds that for Northern Ireland alone, a reduction in the corporate income tax rate to 12.5% may pay for itself over a period of 20 years, but that the shorter-term up-front costs are substantial, and that much of the additional investment and profits are displaced from the rest of the UK, reducing overall UK-wide tax revenues.[15] Thus, although subject to wide margins of error, the Scottish government's estimates do not look entirely unreasonable: in the long term, a lower corporate tax rate would likely boost output, employment and wages. However, the substantial short-term costs of the policy, and the fact that the rest of the UK may respond to the loss of revenues and investment by cutting tax rates itself, mean that the policy carries risks.

As discussed in the previous section, it seems likely that an independent Scotland would face budget deficits in the early years after independence. If the government of an independent Scotland wanted to achieve a balanced budget but to do so in a way that limited the cuts to public spending, it would require tax increases rather than tax cuts.

4. Public spending and the White Paper

The White Paper sets out a number of changes to public spending that the current Scottish government says it would enact in an independent Scotland. Taken together, the plans would increase the level of public spending – at a time when Scotland is likely to be facing continuing budget deficits and is therefore likely to be facing pressure to instead cut spending. Meeting the pledges set out would therefore require deeper cuts to other public spending, or tax rises.

There is one area of spending on which the Scottish government says it would spend substantially less than the UK government currently does on behalf of Scotland: defence. In 2012–13, GERS estimates that defence spending for the benefit of Scotland totalled £3.0 billion. Given the planned cuts to the UK defence

[14] HM Revenue & Customs and HM Treasury, *Analysis of the Dynamic Effects of Corporation Tax Reductions*, 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263560/4069_CT_Dynamic_effects_paper_20130312_IW_v2.pdf.

[15] Sir D. Varney, *Review of Tax Policy in Northern Ireland*, HM Treasury, 2007, http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.178.3894.

budget,[16] this looks set to fall to around £2.9 billion in 2015–16, the last full year Scotland would remain part of the UK, if it votes for independence. The Scottish government's plans for spending £2.5 billion a year therefore represent a reduction of around £400 million compared with the spending it would inherit, although, of course, there may be some transition costs which would prevent these savings from being realised immediately. It is beyond the scope of this briefing note to analyse what kind of defence force would be achievable with a budget of £2.5 billion.[17] But, as we have pointed out before, there may well be scope for further cuts. Such a level of spending, which is likely to represent around 1.6% of an independent Scotland's GDP, would be above the average for small advanced economies (approximately 1.3% of GDP in 2011) and much higher than the 0.6% of GDP spent by the UK's nearest neighbour, Ireland.[18] A cut to the level of defence spending in Ireland could provide a further £1.5 billion for other uses, such as easing the pressure on other public spending or allowing greater deficit reduction. But it would take Scotland far below the level of spending supposedly mandated for NATO membership (2% of GDP; Ireland is not a NATO member) and would obviously have big implications for the type of defence capabilities Scotland could achieve.

The planned spending increases, on the other hand, are largely in the broad area of welfare and family policy. This includes areas presently under the control of Westminster – such as benefits, tax credits and pensions – and areas already under the control of the Scottish government, such as childcare.

Benefits and pensions

On benefits, the current Scottish government says it would:

---

[16] See *Public Expenditure Statistical Analyses 2013: update for 2015–16*, October 2013, https://www.gov.uk/government/publications/public-expenditure-statistical-analyses-2013-update-for-2015-16.

[17] The SNP says that such funding would allow Scotland to have armed forces numbering 15,000 regular personnel and 5,000 reservists (and allow it to maintain historic Scottish regiments), as well as to maintain existing naval and air bases and to fund modest naval and air forces. See http://www.scotsman.com/news/politics/top-stories/in-full-snp-resolution-on-nato-1-2414919.

[18] World Bank public sector financial statistics available at http://data.worldbank.org/indicator/MS.MIL.XPND.GD.ZS/countries.

- halt the roll-out of universal credit and personal independence payments (PIPs, the replacement for disability living allowance, which is intended to be more stringent);
- increase the level of carer's allowance to the same level as jobseeker's allowance and income support;[19]
- keep housing benefit as a separate benefit that is paid directly to landlords;
- reverse recent cuts to housing benefit for social tenants who the UK government deems are under-occupying social housing (that is, 'abolish the bedroom tax');
- set the new single-tier state pension at £160 a week in April 2016, £1.10 a week higher than the rate currently expected for the UK (and match the UK rate if that is increased above £160 a week); the triple lock would also be retained for the single-tier pension until at least 2020;
- retain the savings credit element of pension credit beyond April 2016. (It will be abolished for those reaching the state pension age after this date under UK government plans.)

In the short term at least, the most expensive of these proposals is to halt the roll-out of PIPs. The Department for Work and Pensions estimates this would cost over £300 million a year by 2017–18, by increasing the number of people entitled to support (the tougher tests used in PIPs are expected to reduce claimant numbers by around 20%).[20] This is not included in the White Paper's costings of priority measures, despite it being listed as a priority.

Halting the roll-out of universal credit is much less costly but would affect far more people. This is because universal credit is largely revenue neutral – increasing entitlements for some people, but reducing entitlements for others. The UK government argues that not rolling out universal credit would hit the 300,000 households who will have higher entitlements under universal credit than under the current benefit system (to the tune of £166 a month, on average). This is true but it would also benefit those households who are set to lose out

[19] This policy was not announced in the White Paper but following the final report of the Expert Working Group on Welfare: http://news.scotland.gov.uk/News/Government-responds-to-Welfare-Report-d33.aspx.

[20] HM Government, *Scotland Analysis: Work and Pensions*, 2014, https://www.gov.uk/government/publications/scotland-analysis-work-and-pensions. This is also the main source for further costings of welfare policies.

under universal credit, who are likely to be almost as numerous.[21] The UK government also argues that failure to roll out universal credit will leave financial work incentives worse in Scotland, reducing employment and tax revenues and pushing up benefit spending. IFS analysis suggests that it is true that universal credit improves financial incentives to work, on average, and particularly for those who currently face the weakest incentives.[22] However, work incentives are not improved for all people, and while most estimates suggest universal credit will increase employment, not all estimates do.[23] It is perhaps unsurprising that the White Paper focuses on the winners from the decision to halt the roll-out and that the UK government's analysis focuses on the losers – but the true picture is more nuanced.

Reversing the decision to reduce housing benefit for social tenants who the UK government deems to be under-occupying their homes would cost around £50 million a year, and would return Scotland to a system where social tenants are treated more generously than private sector tenants. (Private sector tenants have long been only able to claim an amount based on the number of bedrooms they are deemed to need.) Having said that, the Scottish government is already funding a version of this policy via discretionary housing payments to those affected by 'the bedroom tax'; it would make more sense to restore the full value of standard housing benefit formally than to continue with such an ad hoc scheme in an independent Scotland. Keeping housing benefit as a payment paid directly to landlords may also have some benefit for those tenants who struggle to manage their money and, through fewer problems with rent arrears, for their landlords. But if it were kept as a separate payment, it would be important for it to be properly integrated into the rest of the benefit system – otherwise it could create unnecessary complexity for claimants and may adversely affect work incentives.

The costs of the planned pensions policies are moderate in the short to medium term, but will build up over time. For instance, the Department for Work and

[21] The latest DWP impact assessment, for instance, suggests that across the UK as a whole, universal credit will make 3.1 million households better off and 2.8 million households worse off in the long run. See https://www.gov.uk/government/publications/universal-credit-impact-assessment.

[22] S. Adam and J. Browne, 'Do the UK government's welfare reforms make work pay?', IFS Working Paper W13/26, 2013, http://www.ifs.org.uk/publications/6853.

[23] D. Phillips, 'How might labour supply respond to the changes in financial work incentives?', 2013, http://www.ifs.org.uk/publications/6855.

Pensions estimates that the plans for the single-tier pension and pension credit will cost just £10 million a year in 2018–19, but this is forecast to grow to around £130 million a year in today's terms 10 years later and £240 million a year 20 years later.[24] This reflects the increasing numbers of people who would benefit from these policies as time goes by.

The policy to triple lock the single-tier pension, if extended beyond the first parliament of an independent Scotland, would also become increasingly costly: perhaps close to 1% of GDP a year (between £1.4 and £1.5 billion in today's terms) by the 2060s. As we have previously argued, the triple lock is a fundamentally flawed way of uprating pensions over time. If the government of an independent Scotland (or indeed the UK) wanted to increase the generosity of the state pension by more than earnings growth, there are more transparent ways of doing so.[25]

The White Paper also says that the Scottish government would review another important part of the state pension system – the state pension age. Under current UK government plans, this is due to increase to 66 between 2018 and 2020, to 67 between 2026 and 2028, and to 68 between 2044 and 2046. In an independent Scotland, the Scottish government would go ahead with the increase to 66, but 'will reserve judgement on the increase to 67' which is 'a concern ... as it is a significantly faster timetable than that announced by the previous Westminster government'. The White Paper goes on to point out that lower average life expectancy in Scotland means that Scots, on average, currently receive state pensions for a shorter time period than people in the rest of the UK.[26]

[24] To calculate this, the percentage of projected benefit expenditure in Scotland in 2028–29 and 2038–39 accounted for by these policies was multiplied by 2012–13 levels of benefit spending.

[25] D. Phillips, 'Government spending on benefits and state pensions in Scotland: current patterns and future issues', IFS Briefing Note BN139, 2013, http://www.ifs.org.uk/publications/6818.

[26] Page 141 of Scottish Government, *Scotland's Future: Your Guide to an Independent Scotland*, 2013, http://www.scotreferendum.com/reports/scotlands-future-your-guide-to-an-independent-scotland/. These arguments have recently been reiterated in updated analysis from the Scottish government, the accompanying material to which hints strongly that the current government of Scotland would delay the increase in the state pension age in an independent Scotland (http://news.scotland.gov.uk/News/Life-expectancy-and-state-pensions-c6b.aspx).

All this is true. It might be expected that lower life expectancy would mean that a lower state pension age is relatively less costly than in the rest of the UK, but that is not the case. This is because the UK and, at least on current plans, an independent Scotland operate a pay-as-you-go pensions system, where the taxes paid by current taxpayers pay for the pensions of retired citizens (rather than a funded system, where those pensions are paid for by those retired citizens' earlier pension contributions). Under a pay-as-you-go system, the key variable that matters for the affordability of the system is not life expectancy itself, but the ratio of retirees to working-age people.[27] In particular, the cost of keeping the state pension age at 66 instead of raising it to 67 will depend upon the relative share of 66-year-olds in the population. In the late 2020s and early 2030s, ONS projections suggest 1.3% of Scots will be aged 66, compared with 1.2% of people across the UK as a whole.[28] The relative cost of postponing the state pension age increase is therefore likely to be a little higher for Scotland than it would be for the UK.[29]

In absolute terms, the costs would also be substantial. The UK government estimates it would represent an increase in benefit spending in Scotland of 3.1%, which is equivalent to around £550 million per year in today's terms.[30] This is not to say that there is not a case for a lower state pension age – but it should be recognised that this would be costly for a society that is ageing even more rapidly than the rest of the UK and would mean tougher choices in other areas of spending and/or taxes.

---

[27] And the generosity of pensions relative to earnings and, hence, tax receipts.

[28] Tables A3-1 and A3-6 of *National Population Projections, 2012-Based Projections*, 2013, http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-318453.

[29] The Scottish government argues that such a policy is more affordable for an independent Scotland because benefits and pensions spending as a share of GDP in Scotland is lower than that for the UK as a whole. However, affordability of public spending is best judged by looking at spending and the public finances as a whole rather than at particular items in isolation. Doing this suggests that Scotland is likely to face a more challenging fiscal position than the UK, particularly in the longer term. See M. Amior, R. Crawford and G. Tetlow, *Fiscal Sustainability of an Independent Scotland*, IFS Report R88, 2013, http://www.ifs.org.uk/publications/6952.

[30] Note that, in practice, this is likely to be a lower bound on the cost of the policy as, in addition to higher pension payments, if people retire earlier in response to the policy they will also pay less tax.

Childcare

The biggest spending commitments in the White Paper are the plans for a substantial expansion of free childcare provision. This would take place in a number of stages. In its first Budget post-independence, the current government of Scotland suggests that it would provide 600 hours of childcare to around half of 2-year-olds. Later, in its first term, it would extend this to 1,140 hours of care to half of 2-year-olds and all 3- and 4-year-olds. In the long term, the aim would be to extend this provision to all 1- to 4-year-olds.

Undoubtedly, this policy would be popular with parents – especially with those who are currently paying for childcare – but it would also be costly. The Scottish government estimates that the cost of the first phase of the scheme would be £100 million, rising to £700 million for the second phase.[31] The Scottish Parliament Information Centre (SPICe) estimates that, when extended to all 1- to 4-year-olds, the policy will cost £1.2 billion a year.[32]

A recent survey of evidence on the effects of childcare provision by IFS researchers found that there are some positive effects.[33] For instance, there is good evidence that high-quality childcare benefits the development of children from disadvantaged backgrounds. However, robust evidence on the impact on parents' employment is surprisingly limited. Most studies find either no effect or only a small positive effect of expanded childcare provision on the labour supply of mothers, although there are some well-publicised exceptions. The SPICe study comes to broadly the same conclusions, although it also cites survey evidence in which 30% of parents of pre-school children say they would be likely to start work or increase their hours of work if childcare were free.

The Scottish government has not estimated the likely impact of its childcare plans on parents' labour supply. However, it has provided some indicative figures for the additional numbers of people in work, the size of the economy and the state of the public finances *if* the policy led to a 2, 4 or 6 percentage point increase in the overall employment rate of women. These scenarios would imply

[31] Scottish Government, 'Childcare and female labour market participation', 2013, http://www.scotland.gov.uk/Resource/0043/00439259.pdf.

[32] Scottish Parliament Information Centre, *Early Learning and Childcare*, SPICe Briefing SB 14-26, 2014, http://www.scottish.parliament.uk/parliamentarybusiness/75145.aspx.

[33] M. Brewer, S. Cattan and C. Crawford, 'State support for early childhood education and care in England', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, 2014, http://www.ifs.org.uk/budgets/gb2014/gb2014_ch8.pdf.

an additional 35,000, 68,000 and 104,000 women entering the workforce respectively. Using the final scenario, the Scottish government estimates that GDP would increase by £2.2 billion a year and that tax revenues would increase by £700 million a year in the long run.

SPICe's analysis highlights a number of issues with this modelling. Among the critiques is the fact that it assumes that the newly employed women would enter work on average wages and average hours of work. The most important critique, however, is on the scale of employment effects chosen as indicative scenarios. In particular, in 2011 there were 64,000 economically inactive mothers in Scotland whose youngest child was aged between 1 and 5. Even a 2 percentage point increase in participation – which might be expected to boost tax revenues by about one-third as much as a 6 percentage point increase – would require more than half of these women to enter the workforce; this compares with just 14,000 of them (or less than one-in-four) who reported that they would like to work. The other two scenarios would require all of the economically inactive women to enter the workforce *and* require the policy to influence the labour market decisions of a larger group of women who were not directly affected by the reform. This is not impossible but, given the limited evidence for strong effects of childcare provision on parental employment, is perhaps an incautious assumption to make.

The Scottish government's analysis is careful to make clear that its results '[illustrate] the impact of a boost in female participation rates rather than a specific policy'.[34] But the usefulness of such optimistic illustrative scenarios is questionable. Scottish government ministers have also not always been as careful as official Scottish government publications when referring to these figures – sometimes suggesting that they have estimated the impact of the policy and that results show that costs could be met through resulting higher tax payments.[35] The Scottish government's analysis does *not* show this and, indeed, it seems more likely that any increase in labour supply in response to the policy could only pay for a small part of the £1.2 billion in additional spending required, although it is true – as the Scottish government says – that more of the costs of

[34] Footnote 4 of Scottish Government, 'Childcare and labour market participation: economic analysis', 2014, http://www.scotland.gov.uk/Resource/0044/00441783.pdf.

[35] See, for instance, Nicola Sturgeon's speech to the Scottish Council for Development and Industry reported in *The Scotsman*: http://www.scotsman.com/news/politics/top-stories/sturgeon-brands-further-devolution-plans-inadequate-1-3326757.

the policy could be recouped under devolution (or under a system with further devolution of taxes) than under existing arrangements.

5. The White Paper 'scorecard'

The independence White Paper takes two approaches to selling independence to the Scottish people. First, it sets out the additional powers Scotland would have under independence and the benefits that the Scottish government thinks these would bring. Second, it plays the role of a manifesto – saying what the current Scottish government would do with those powers if it were elected in an independent Scotland. As such, it offers some specific policy proposals for the first year and first term of an independent Scotland and indicates other priorities for taxation and public spending in the longer term. But in doing this, it does not set out a fully costed plan for how these policies can be paid for, although the plans for the first Budget are designed to be broadly fiscally neutral.

As described in the preceding sections, there are some specific measures that would reduce spending / raise revenue:[36]

- reducing defence spending to £2.5 billion a year (saving £400 million a year);
- abolishing the transferable personal allowance (saving £70–£80 million a year);
- abolishing the 'shares for rights' scheme (saving £10–£15 million a year).

These would all be undertaken in the first Budget. Over the course of the first parliament, there would also be an aim to raise an additional £235 million from further, as yet unspecified, measures to remove tax exemptions and reduce tax avoidance.

But the spending increases / tax cuts planned or hinted at are more numerous and more valuable:

- expanding free childcare (costing £100 million a year in phase 1 but rising to £1.2 billion a year in phase 3);
- halting the roll-out of PIPs (costing £300 million a year);
- paying for the services currently funded by the Energy Company Obligation and the Warm Homes Discount charges added to bills (costing around £150 million a year);

[36] All savings and costs are pounds *per year*.

- increasing housing benefit for those who the UK government deems are under-occupying their homes (costing £50 million a year);
- increasing carer's allowance to the same level as jobseeker's allowance (costing £60 million a year);
- increasing the generosity of the single-tier pension and retaining the savings credit element of pension credit (costing little in the short term but around £240 million a year in today's terms by the late 2030s);
- potentially delaying the state pension age increase from 66 to 67 (costing at least £550 million a year in today's terms for each year that the increase is delayed);
- reducing air passenger duty by 50% with an aim of abolishing it (costing up to £230 million a year in the short term);
- reducing corporation tax by 3 percentage points (costing up to £270 million a year in the short term).

Some of these policies may have dynamic behavioural effects that mean that they could in part pay for themselves – notably, the cuts to corporation tax and air passenger duty and the increased provision of free childcare. Even taking account of this, though, the spending cuts and tax rises outlined do not look to be enough to pay for all of the proposed giveaways.

This does not mean that such a package of reforms is infeasible. But, with a background of budget deficits, enacting these measures looks as if it would require bigger cuts to other public services or benefits, or other tax rises, if the government of an independent Scotland were to ensure that its public finances were not adversely affected and remained sustainable.

6. Conclusions

Independence would give the Scottish government additional powers over taxation and areas of spending that are currently the preserve of the UK government. This would give Scotland greater freedom to design a system of taxes that meets its needs and aspirations and, if it were willing, correct some of the failings of the existing UK system. It would also allow Scotland to redesign public services and welfare provision and to change the areas it prioritises for public spending. Scotland would also have more choices about whether it wanted to be a lower-tax, lower-public-spending country or a higher-tax, higher-public-spending country. But it would still face the same need to ensure its tax and spending policies were consistent with a sustainable fiscal position.

Possible independence in 2016–17 looks likely to take place against a fiscal backdrop of ongoing deficits – which, if North Sea revenues decline as expected by the Office for Budget Responsibility, would likely be larger than those faced by the UK. This means that the government of an independent Scotland would likely need to make further spending cuts and/or tax increases after the date of independence if it wanted to bring borrowing in Scotland down to sustainable levels. The exact scale of the fiscal challenge facing an independent Scotland in the medium term would be sensitive (among other things) to the amount of revenues that are generated in future from oil and gas production and to the outcome of negotiations between Scotland and the rest of the UK about the share of existing UK debt that an independent Scotland would service.

It is not surprising that the independence White Paper does not say how the Scottish government would address these fiscal issues – the UK government has yet to give much detail about how it would deliver the fiscal tightening planned between 2016–17 and 2018–19 (such as what areas of spending would be cut). Instead, the White Paper focuses on a set of policies and principles that the Scottish government believes present a positive agenda for an independent Scotland. The broad principles and a number of specific policies do look sensible – a lower rate of corporation tax is likely to prove attractive to a small open economy such as an independent Scotland, for instance. And a number of cuts to spending and increases in tax are mooted which could, in principle, help balance the books. But the spending *increases* and tax *cuts* pledged or hinted at are more numerous and, more importantly, substantially larger. The government of an independent Scotland could, of course, choose to prioritise these policies – independence would give that freedom. But in a difficult fiscal context, substantial giveaways in some areas would make the job of restoring the public finances to health more difficult and would require bigger spending cuts or tax rises in other (lower-priority) areas. Thus, underlying the attractive policies outlined in the White Paper are difficult, unmentioned, decisions for other public services and taxes.