

Cabinet Secretary for Finance and Sustainable Growth
David Hume Institute – 16 April 2009
Scotland's Financial Future

Introduction

1. I welcome the opportunity to speak with you tonight on Scotland's financial future. For almost a quarter of a century, the David Hume Institute has provided a forum for some of the most important policy issues facing our nation to be considered, including most recently demographic change, climate change and public sector reform.
2. On the very topic that I will discuss tonight the Institute published a weighty document 'Options for Scotland's Future - the Economic Dimension' in November last year.
3. Tonight I will discuss Scotland's financial future and the need for reform to ensure that Scotland will flourish and take advantage of the opportunities that will arise in the years ahead.
4. For far too long we have been at the mercy of financial and economic decisions taken outside Scotland. Now is the time for change and I am encouraged by the growing consensus that is emerging among our politicians, our business leaders, and the people of Scotland on the need for such change.
5. However, any reform must offer the people of Scotland a genuine advance. Not cosmetic alterations, but real substantial, progress that allows us to decide how to invest for our future and protect and enhance our natural environment. We must take this opportunity to be bold and ambitious in our outlook for Scotland.
6. As we move to mark the 10th anniversary of the reopening of the Scottish Parliament it is right to consider these points and these challenges.
7. Devolution has allowed us to make significant progress with policy – and in many areas of government, there is now a distinctly Scottish feel. The stature of our Parliament – and standards of public debate in Scotland (helped by the Institutions such as this one) – have risen, and are continuing to rise.
8. Against this background however, we must consider how Scotland faces up to the significant economic, financial and constitutional challenges that now confront us.
9. There are two threads that will run through my talk tonight. Firstly, the current economic climate. And secondly, the outlook for public finances in Scotland. Both themes, through a combination of external shocks and fiscal and economic mismanagement by the UK Government present a real challenge to Scotland in the years ahead.
10. Both these themes create the foundations for the final aspect of my remarks tonight – how we can ensure the best, strongest future for Scotland and the pressing need to

ensure this is delivered by fiscal and constitutional reform. The view of the Scottish Government is clear. Only by Scotland and her Government and Parliament taking full economic and financial responsibility can we guarantee the best opportunities to ensure long-term economic success and financial sustainability. There are of course other views and possibilities, something that our National Conversation is open to, and I will consider these this evening

The Scottish Government's Achievements and Purpose

11. Before I discuss these issues though, I want to talk about the approach we have taken since we came to power after the Scottish Parliamentary elections in May 2007.
12. 22 months ago, when this Government was formed, we said that it was time for a fresh approach and an agenda for government that would put Scotland on course for long-term success. We said it was time for Scotland to move forward – and, we have been working every day since to tackle the deep-seated issues and deliver the improvements that will help our nation flourish. We have worked to deliver this new environment within a context of governing without a majority, highlighting the importance of creating greater consensus around the actions of government.
13. We have delivered on our early priorities – lifting bridge tolls; reducing business rates; freezing the unfair council tax; and phasing out prescription charges.
14. Because of these changes, people in Scotland can now feel the difference this SNP Government is making to their lives.
15. We are already building a nation that is healthier, with better and more local health services; with communities that are safer, with a more visible police presence on our streets; families who are better off, with the lower council tax bills leaving more money in people's pockets at the end of every month; and businesses which are more competitive through the Small Business Bonus Scheme.
16. When we came to Government, we did so with one central priority in mind.
17. From day one, our overarching Purpose has been to focus government and public services on creating opportunities for all of Scotland to flourish through increasing sustainable economic growth in Scotland.
18. Through our spending reviews and our economic strategy, we have put sustainable economic growth at the heart of everything we do.
19. That was essential to give a focus to Government- a focus that had been singularly absent during the previous eight years of initiative overload. That focus I would contend has begun to create a more effective climate within the public sector in Scotland and a more robust basis upon which to make decisions in the period ahead.

20. This has been our commitment since the start, and as the effects of the global economic downturn have started to impact on Scotland, we have responded to help keep our programme on track.
21. The economic and financial challenges that we currently face do not necessitate a change of purpose for Government. They herald a need to intensify our focus and generate new opportunities.

Recent Economic Events

Global Financial Crises

22. The events which have taken place in global markets over the past 18 months are almost without precedent. Global economic stability has been taken for granted in recent decades. But this year world GDP and exports are expected to fall for the first time since World War 2.
23. There is not yet a consensus of how the crises can be resolved. However there appears to be general agreement that the immediate cause of the crises stemmed from two powerful external shocks during 2007 - the international financial crisis, which has been closely associated with a credit crunch, and a severe commodity-price shock. The latter may have subsided but we remain open to the full effect of the fallout from financial markets.
24. The origins of the financial market instability can be traced back to the growing imbalances in the World economy that built up since the mid-1990s.
25. High levels of savings in the East were coupled with the high levels of borrowing and spending in the West.
26. This resulted in a flow of capital from the East to the West. The flood of extra money led to lower interest rates in Western economies. Lower interest rates meant cheaper credit. This allowed more people access to credit, which helped fuel booms in asset prices in many Western economies – particularly in the housing market.
27. Lower real interest rates also meant lower returns on many assets. Investors, including many financial institutions, looked for new ways to increase their returns. This led to the creation of new financial instruments, which were partly designed to increase the returns on capital.
28. The potential for higher returns normally requires investors to accept greater risks. Many of these new financial instruments, such as Collateralised Debt Obligations, were partly intended to redistribute risk. But in effect, these instruments acted to increase the exposure of the entire global financial system to risky assets, in effect acting as Warren Buffett predicted they would, as ‘financial weapons of mass destruction.’

29. These risks began to become apparent following the problems in the US sub-prime mortgage market in the summer of 2007 and started to impact negatively on the balance sheets of financial institutions in many advanced economies.
30. This, as is painfully clear to households and businesses across the world, led to a severe tightening of credit conditions around the globe.
31. In September 2008, the credit crunch deteriorated very sharply into a crisis of confidence in financial markets – exacerbated by the collapse of a number of financial institutions including Lehman Brothers.
32. These problems have of course manifest themselves at a time when the UK has enjoyed sustained periods of economic growth. It is therefore amazing that the previous UK Chancellor-now Prime Minister - is ready to claim credit for the successes but is conspicuously absent in accepting responsibility for the failures.
33. The credit crunch contributed to a systemic financial crisis – which many economic commentators reckon to be the most severe since the 1930s - and the near-collapse of several of the largest financial institutions around the world.
34. The turbulence in financial markets has since spilled over into the real economy with unemployment rising as business activity has fallen across the world.

Small countries in the downturn

35. It has been argued in recent months that an independent Scotland would have been worse off in the face of recent events.
36. That small countries are more vulnerable in the global economic crises. And that this is economic justification for maintaining the union.
37. I strongly reject such an argument for three reasons.
38. Firstly, we should remember how we arrived at the situation we are in – we arrived where we are as part of the United Kingdom not as an independent Scotland. None of the difficulties we have faced in the last twelve months have come about as a consequence of independence. They have come about under the watch of the current UK Government within the structure of the Union.
39. We are living with the consequences of decisions taken at the UK level on fiscal deficits, the costly experiment with PFI, and a regulatory system that has been unable to respond to current challenges in the banking and wider financial system.
40. And consider this – at one time, America, Canada, Australia and Ireland all had their financial decisions made by London. And now they are each wealthier per head than the UK. So clearly there is nothing endemic in Union with Westminster that leads to economic success.

41. Secondly, the downturn is affecting countries across the world, irrespective of size. There is not a country in the world that has not been affected by the financial crisis. And we should resist at all costs taking on the burden of all of this on Scotland's shoulders.
42. Yes we have had major failures through HBOS and RBS but we have many, many other successful financial institutions and we talk down the strength of this sector in Scotland at our peril.
43. Consider the United States which has had 50 bank failures since 2008. 50 times the federal deposit insurance corporation has had to intervene – and that doesn't even count things like the merger of Merrill Lynch. And yet the debate in America has been about how the country moves on, not on basic questions of whether the country can move on. American commentators have not extrapolated these corporate failures to a national crisis of confidence. They know the country will get through this. We should have that same confidence in Scotland and Scotland's businesses too.
44. Consider also two countries both much smaller than the United Kingdom: Canada – who I just mentioned – and Norway. According to the FT, Canada's banks are now 'the envy of the world.' And Norway was able to weather a financial crisis in the early 1990s and provide a blueprint much of the rest of the world is now following – this country of 4 million people recently announced that it would be contributing almost \$5 billion to the IMF to help its neighbours. It is also interesting to note that Norway's oil fund is four times the size of the total recapitalisation package for UK banks.
45. So is there one person here who honestly believes that the Canadian Parliament would wish to return to the days when London made its fiscal decisions or that Oslo is unhappy with Norwegian independence?
46. It is disingenuous to claim that the effects of the downturn are unique or more acute in small countries. And consider that while Ireland is in recession, so is the UK. It's just that Ireland entered this recession considerably wealthier than the United Kingdom did.
47. Once again, we are reminded that it is not size that matters, but smart policy.
48. According to the OECD, the UK's own economy will shrink by 3.7% in 2009. And, while many countries are forecast to return to growth in 2010, the UK is expected to remain in recession.
49. Thirdly, while admittedly difficult at this time, when focussing on economic growth it is important to consider the long term performance.
50. Economic fluctuations and cycles are endemic and it is important to bear in mind that no matter how difficult or bleak the outlook may be at this time, the world economy will recover.

51. Growth in Ireland has averaged 6.9% over the last 10 years, far outstripping Scotland. Therefore, while Ireland is forecast to experience significant retrenchment this year, it is doing so from a base well above that of Scotland.
52. The evidence is not just restricted to Ireland. The experience of other small independent countries shows that sustainable economic success can be achieved.
53. Over the last thirty years, comparable independent European nations have grown at an annual rate of 2.7% - this outstrips both Scotland's growth and that of the United Kingdom.
54. The real distinction in the current economic crisis does not concern size. It concerns how well prepared each individual country is to respond to economic shocks. And as I will set out, the UK Government was poorly prepared when entering this recession as a result of the high levels of debt and poor economic management over the past ten years.

Scotland and the Downturn

55. No nation has proved itself to be immune from recent economic events – and, Scotland is certainly no exception to that rule. The reality of the recession is now hitting homes and high streets throughout the country.
56. The GDP statistics released next week will almost certainly confirm that Scotland has followed the rest of the UK into recession.
57. Here in Scotland, unemployment might be lower, comparatively, than in other parts of the UK – but, it is on the rise and there is no room for complacency. Jobs and livelihoods are under threat across the country, and this SNP Government is working with every energy to keep people in work and to keep our companies trading at this time.
58. It is worth remembering, too, that even amidst this global economic downturn, Scotland has sectors of comparative advantage that can be strong sources of future growth.
59. Take Life Sciences where Scotland is at the forefront of medical discoveries. Today Scotland is home to more than 600 life science organisations who employ over 30,000 highly skilled staff.
60. Or consider one of our greatest economic prospects - renewable energy.
61. Scotland is already enjoying a green dividend, and stands at the cusp of an enormous growth in the market for offshore renewables. We have a major competitive advantage in this race. We hold up to 25 per cent of Europe's offshore wind, wave and

tidal energy potential. And we punch well above our weight in terms of scientific research capacity.

62. However, we must be prepared to do more. We face major challenges with the loss of employment and the loss of business activity. Behind the economic statistics are real people who have the skills and willingness to work but are currently unable to access good jobs and rewarding careers.

63. That is the reality of the recession across Scotland. We have pledged to do all that we can to support individuals and to secure alternative employment should they face unemployment.

Scottish Government Economic Recovery Programme

64. As you are no doubt aware, most of the short term macroeconomic levers for responding to the economic crisis rest with Westminster. But this Government will use every power at its disposal to stand up for the interests of Scottish households and businesses at this time.

65. Last October, we announced a six-point economic recovery programme for Scotland – more than a month ahead of the UK Government’s own stimulus package. This programme outlines how the Scottish Government is using all the resources at our disposal to support Scotland’s economy.

66. This is not the only example of how we have reacted much more quickly than the UK Government.

67. We were a full five months ahead of England and Wales in bringing forward our allocation of European Structural Funds last August to give Scotland’s economy a shot in the arm.

68. That same month we also announced we were accelerating £100 million in money for investment in affordable housing – three months ahead of the UK Government – and culminating in a record £644 million investment in affordable housing in Scotland.

69. Through our Economic Recovery Programme, and as a consequence of decisions taken by the Chancellor at the Pre-Budget Report, we have brought forward a total of £323 million of capital spending to deliver an immediate, substantial economic boost.

70. Most of this money will go into shovel-ready infrastructure projects and support around 5,800 additional jobs in Scotland.

71. And this is on top of the thousands of jobs we are already supporting through this Government’s record £14 billion capital spending over the current spending review period.

72. We believe that investing in infrastructure is exactly the right thing to do at this time. By making this investment we are providing a direct stimulus to the economy. Keeping thousands of Scots in work. And leaving a lasting legacy of new schools, hospitals, and homes which will give Scotland a competitive advantage for years to come.
73. And, as we invest in infrastructure, we will do so by traditional funding models and not by the discredited PFI.
74. As Lord Rogers, the UK Government's very own business ambassador has said, PFI is "too complicated and doesn't produce good buildings".
75. What's more, PFI now can't even finance itself – the market has collapsed. And there is a growing realisation of the financial cost of this experiment.
76. It is a black hole that has already drawn in £2 billion of emergency funding from the UK Government.
77. When this Government came to office it was planned that we should spend £501 million on PFI repayment costs in 2007-08. By 2011-12-the end of this Parliamentary term-the annual cost of PFI will be £867 million. In the course of four years I have to find in total £2.7 billion in cash terms of new money to fund PFI. And that has to be found from a budget which is now largely static in real terms and may even fall in real terms in the years ahead.
78. PFI is one of the worst excesses of the age of financial irresponsibility. Politicians have made vast 30 year financial commitments of growing scale and growing impact in the full knowledge that the growth years of public spending were coming to an end. That is the summit of financial irresponsibility. Our approach on infrastructure investment will be to make every single penny count and we have established the Scottish Futures Trust to help us in that process of releasing maximum value.
79. Through our Economic Recovery Programme, we are working to ensure that all Government activity, including on planning, regulation and public procurement, supports economic development in all parts of Scotland. Government is now paying business suppliers within ten days – and, is looking to the rest of the public sector in Scotland to do the same.
80. We are intensifying our support for Homecoming 2009 to encourage £40 million of tourist activity and create more than 1,000 new jobs. We are well on track to achieving those objectives and to meeting our target of bringing in 100,000 additional international visitors to Scotland this year.
81. We are increasing support to businesses.
82. We are doubling the size and capacity of the Scottish manufacturing advisory service to ensure that even more companies can access quality advice in these difficult times.

83. At the same time, we are improving financial advice and support to vulnerable individuals.

84. These are just some of the actions we have taken to date. But, we are far from finished – wherever we can, we will look for new actions to support the Scottish economy in the months and years ahead.

The Need for a Fiscal Stimulus

85. The actions we are taking for recovery are sensible, positive and significant measures.

86. They show that this Government is seeking to use every lever we have to promote economic recovery.

87. But it remains a fact the Scottish Government's budget is effectively fixed by the Barnett formula – a mechanism that predetermines how much Scotland's Government can spend irrespective of the wishes of the Scottish people or economic circumstance. By implication, and in this sharp downturn, we are constrained in our ability to reflate the economy and have to rely on the decisions of a government in London.

88. At this time of greatest need we have one hand tied behind our back - and decisions, more often than not, wrong decisions, are being taken on our behalf.

89. Let me be clear. Whatever the impact of monetary policy – be it interest rate cuts, quantitative easing, providing liquidity to the banks – a short term, well targeted, fiscal stimulus is vital to providing a significant boost to the economy in times of need.

90. This was the right course of action in the 1930s and remains the right course of action today.

91. The International Monetary Fund – so often the guardian of fiscal prudence – has pressed governments worldwide to borrow to reflate their economies and stave off a “great recession”.

92. In the US we see the Obama administration already injecting a stimulus of over 5% of GDP - \$787 billion – into the economy over the coming years to ensure recovery.

93. The bulk of that stimulus is being delivered where it can work best. On the ground. At state level.

94. Maryland – which has a similar population to Scotland – will receive some £2.6 billion extra funding. This is estimated to support 66,000 jobs in the state over the next two years.

95. Contrast that with the approach in the United Kingdom.

96. The UK direct fiscal stimulus package is – at 1.5% of GDP – only one-quarter the size of America's. Even accounting for the impact of automatic stabilisers, such as more generous unemployment benefits, the UK response is timid and lags behind the action taken by many EU countries
97. Moreover, the centrepiece of the UK package, the cut in VAT, expires at the end of this year and it is becoming increasingly accepted that the money would have been better spent elsewhere.
98. Not only will the VAT cut bring no lasting benefit, but we are seeing increasing evidence that it is having only a marginal impact on the real economy.
99. Our analysis, conducted shortly after the Chancellor's announcement, showed that had the £12 billion used to finance the cut in VAT been instead directed toward infrastructure investment it would have supported twice as many jobs – an equivalent capital spending programme would have supported almost 15,000 jobs in Scotland.
100. Indeed, this analysis is likely to overestimate the impact of the VAT cut. It assumed that the VAT cut would have a real effect on the economy. We are seeing increasing evidence that this is not the case.
101. The latest inflation figures suggest that many prices have already returned to November levels as businesses reverse the cut in VAT. While a Federation of Small Businesses survey found that 97% of small businesses believed that the VAT cut has had no impact on their trade.
102. Furthermore, the VAT cut is a temporary measure. Investing in infrastructure would create a lasting legacy for Scotland, be it in schools, roads or hospitals.
103. While we agree that a discretionary fiscal stimulus was, and is, needed – it is clear that the UK Government's stimulus could have been more effective if it was better targeted and focussed on infrastructure investment.
104. In light of the current situation and the outlook for the economy, it is clear to the Scottish Government that a further short term demand stimulus, focusing on capital investment, is vital. It is vital to support immediate employment and output in the economy at a time of spare capacity.
105. I have written to the Chancellor urging him to take bold targeted measures at the Budget. We want him to take the steps that will enable us to provide a boost to the Scottish economy and support employment and output at this critical time.

106. I have also urged the Chancellor to make available to the Scottish Government, Scotland's resources from the Fossil Fuel Fund. This fund currently stands at £150 million and is intended to support investment in renewable energy but is locked in a Treasury bank account. Such investment would provide a vital boost to the Scottish economy at this time. However under current HM Treasury rules the Scottish Government is unable to access these funds without detriment to other spending across the wider Scottish Block.
107. The pressing economic challenges we face and the tightening financial climate make it absolutely crucial the Treasury works with the Scottish Government to find an agreement which allows us to spend the money – and spend it now.
108. At a time when the UK Government is borrowing billions, it is right that we should be able to make full use of Scotland's resources. Freeing up these millions would deliver a huge boost to our renewables sector. The Fossil Fuel Levy funds must now be unlocked to benefit the economy and environment in Scotland. It is a point the Chancellor can and must address when he delivers his budget next week.
109. Alongside this need for fiscal stimulus, it is of course essential to ensure long-term financial sustainability, and there is a need in the future to repair the damage done to the UK public finances.
110. However, this should not preclude the use of short-term, targeted, stimulus measures. Such a stimulus can not only accelerate the economy's recovery but will lay the foundations for long term growth – and a return to fiscal health.
111. We only need to look at the experience of Japan to see the cost of doing too little. Japan offers a cautionary tale to us all. Its slow response to the economic crises they faced in the early 1990s arguably resulted in a prolonged slump – a 'lost decade'
112. In 1990, gross government debt in Japan stood at 65% of GDP. Following a prolonged economic slowdown, this figure now stands at over 170% of GDP.
113. As Martin Wolf said in the Financial Times last month: "The right thing to do is more than enough. It will always be possible to withdraw a stimulus a year or two hence. It will be far more difficult to make action effective if depression, both economic and social, takes hold."
114. Bold measures are required to support the Scottish economy. But balancing the need for a fiscal stimulus with long term fiscal sustainability would not be such a difficult issue had the UK been in a stronger fiscal position at the onset of the downturn. We cannot escape the poor state of the UK public finances and the decisions taken that have led us to this position.

Outlook for the Public Finances

Fiscal Management over the past ten years

115. The UK public finances involve forecast debt in excess of £1 trillion in 2012/13 – a truly mind boggling figure. Equivalent to £17,000 for every person in the UK.
116. However, the deterioration in the UK fiscal position is not the result of this year's stimulus package. As I have said, it reflects years of financial mismanagement by the UK Government – an age of fiscal irresponsibility.
117. The highly respected and independent Institute for Fiscal Studies have shown that even without a fiscal stimulus the UK public finances would be in a desperate state – and would rapidly become unsustainable without long-term action.
118. Although the UK government will be taking money out of the economy next year through cuts in expenditure and increases in taxes, the IMF still believe that - at 11% of GDP - the UK will have the largest budget deficit in the G20.
119. The bottom line is that UK Government's lack of prudence during the good times means that the UK public finances are not well placed to respond to the current downturn. Other nations have managed to avoid this situation – and, it is now becoming increasingly clear that the consequences of high levels of borrowing by the UK Government will be felt across the public sector for years to come.
120. This is in stark contrast to the approach taken by other governments worldwide.
121. As other countries reduced their borrowing, the UK Government continued to increase its reliance on debt.
122. Denmark, Finland and Norway all entered this recession with net fiscal surpluses. Rather than being saddled with debt, all three had assets accumulated in good times to shield their economies from the downturn. In contrast, the UK Government entered this recession burdened down by £600 billion in debt – and don't forget that this figure excludes the legacy of PFI.
123. Take the example of Norway. Unlike the UK which has spent every penny of the revenue extracted from the North Sea, Norway has established an Oil Fund which is now worth nearly £240 billion. For a country with a population of comparable size to Scotland's, that is a more than adequate nest egg - £52,000 per person.
124. It has allowed the Norwegian Government to help stabilise its economy without running up debt for future generations to repay.
125. There is clear blue water between the prudent approach being taken in Norway and the situation on this side of the North Sea – with the UK Government expected to borrow over £180 billion this year.

126. Consecutive UK Budgets have been accompanied by downward revisions in the UK's fiscal position with borrowing and debt consistently higher than forecasted the year before.

127. This time last year the UK Government was predicting a current budget surplus of £4 billion in 2010/11. Now it expects to run a current budget deficit of £73 billion and expects to continue running a current budget deficit for at least the next 7 years. And bear in mind that these forecasts were made only six months ago in the Chancellor's Pre-Budget Report.

Past Growth in Public Spending

128. The decisions taken by the UK Government in previous years are now having a major impact on Scotland's public finances. Following years of growth the public spending climate in Scotland is changing dramatically.

129. The first two administrations of the Scottish Parliament coincided with an unprecedented growth in public spending.

130. Between 2000 and 2007 the Scottish Government budget grew on average by more than 6% a year.

131. This reflected a political consensus across the UK that vital public services such as health and education and the wider public infrastructure needed to be rebuilt following decades of neglect.

132. However this extra spending was not always used productively. It was not accompanied by the public sector reforms necessary to ensure that it was used efficiently.

133. Since 2007 there has been a marked slowdown in UK public spending.

134. The last UK Spending Review – covering 2008 to 2011 – pencilled in growth of 2.1% a year in public spending. Scotland was particularly hard hit with public spending expected to grow by just 1.4% a year on average over this period – the worst financial settlement from the Treasury since devolution.

Outlook for Public Spending

135. It is becoming increasingly clear that the next few years are going to be even tougher.

136. The Chancellor's Pre Budget Report in November announced reductions of £5 billion in UK planned spending in 2010-11 on the basis of 'over-achievement' against earlier efficiency targets. It also announced £1.3 billion of reductions in NHS spending south of the Border.
137. But let me be clear, these are not real efficiency savings. We are already working on an ambitious programme of efficiency savings in Scotland – savings that can be reinvested in lifeline public services. But this is not the case with these so called savings.
138. Taken together, these measures are likely to reduce the Scottish Government budget by £500 million next year – and the year after that – forecasts confirmed by Professor David Bell in his report to the Scottish Parliament's Finance Committee. At a time when spending is needed at its most acute.
139. Let me restate this point. These cuts will amount to £1 billion over the next two years – precisely at a time when public investment is needed most.
140. These cuts will cost nearly 8,700 jobs in Scotland. They will not only lead to reductions in lifeline public services across the country but will undoubtedly hinder our economic recovery.
141. It is right that the UK Government must reduce levels of borrowing in the long-term to pay for past excesses.
142. But cutting the Scottish Government budget in the middle of the recession is the wrong approach. And this gives us a foretaste of the challenges which lie ahead.

Spending Growth after 2011/12

143. Next year's cuts will put immediate pressure on the Scottish Government budget. But looking ahead it is clear that the future public spending climate in Scotland is going to be tight for many years to come.
144. The UK Government has announced that public spending will increase by just 1.1% a year between 2011/12 and 2013/14.
145. This is much lower than the growth experienced in recent years.
146. However the Institute for Fiscal Studies has reported that most of the growth will be taken up by higher spending on social benefits and debt interest. This means that budgets for all our public services will be under significant pressure.
147. The Treasury has yet to announce the precise impact on public spending in Scotland after 2011/12. But what is absolutely clear is that public spending will be severely constrained once more.

148. There is a real risk that the Scottish Government budget could decline in real terms. The Centre for Public Policy in the Regions have estimated that by 2013/14, the Scottish Government budget will be between 2% and 7.5% lower in real terms than in 2009/10 I have significant sympathy with this analysis. And remember this is at a time when fixed cost repayments to PFI will be rising relentlessly.

149. And at a time when Scotland's oil revenue has generated over £13 billion in tax receipts for the UK Government in the last twelve months, a record tax haul, and is expected to contribute a further £42 billion over the next five years. .

150. It is clear that the next five years will present significant challenges across the public sector in Scotland.

Fiscal Autonomy

National Conversation

151. This is why in August 2007, we published a White Paper on Choosing Scotland's Future - opening a full, democratic debate, a national conversation - with the people of Scotland and our institutions.

152. The National Conversation is all about creating the best environment for Scotland to flourish. Scotland's economic responsibilities, including tax, spending and borrowing, are central to this debate.

153. This Conversation is even more important given the challenges presented by the current economic climate.

154. The current devolution settlement has been tested and found wanting.

155. Scotland needs an economic framework to enable the Scottish Government to take decisive action to cut taxation, re-prioritise expenditure and create a competitive business environment. This has long been acknowledged by academics, commentators and politicians from across the political spectrum.

Scotland's current fiscal framework

156. As I have said, the impact of the economic crisis has starkly exposed the limits of Scotland's current fiscal framework.

157. Under the current devolution settlement the Scottish Government has a significant degree of spending autonomy – controlling approximately 70% of identifiable expenditure in Scotland,

158. The Scottish Government also has responsibility for a number of policy areas that affect Scotland's long-term economic performance, such as education, transport, planning and economic development. This gives a degree of real autonomy over devolved policies. Policies which we are using to their full effect to increase sustainable economic growth.
159. However, responsibility for several key areas of economic policy remain largely reserved to the UK. For example science and innovation, social security, defence, employment law and financial regulation are still controlled by the UK Government.
160. And in contrast to the degree of spending autonomy, the Scottish Parliament has only limited revenue raising capacity.
161. Under the current arrangements, the majority of Scottish Government spending is financed by the Scottish Block Grant which is determined by the Barnett Formula. In effect, the vast majority of tax revenues raised in Scotland are set and collected at the UK level before the UK Government determines how much to allocate back to Scotland via the Block Grant. This gives the Scottish Government little control over taxation in Scotland – or the overall size of public spending.

Consensus that reform is required

162. Today in our Parliament there is a broad and growing acceptance that this country will benefit from substantially increased responsibilities – in the economic sphere and wider.
163. That view is also shared by our people – with opinion polls showing strong support for greater responsibilities for Scotland.
164. The Scottish business community is engaging in this debate and starting to articulate the case for more tools to achieve our economic ambitions.
165. And there have been major contributions to the debate from the academic sphere including the paper by the David Hume Institute itself last November – all highlighting the need for reform.
166. We have had a welcome development from the Scottish Labour Party who recently argued for greater fiscal autonomy in Scotland by supporting calls for greater borrowing powers.

Borrowing Powers

167. As I have outlined, we are doing everything in our powers to respond to the current economic situation. However the policy tools available to us are constrained.

168. Other tiers of government within the UK, for example our own local authorities and the devolved administration in Northern Ireland, have greater borrowing powers than the Scottish Government. This is clearly an anomalous situation that must be addressed urgently.
169. For these reasons, the case for borrowing autonomy becomes even more pressing, if we are to protect our households and businesses, and create the stimulus we need to see our economy grow.
170. The obvious question for all of us across Scotland is whether borrowing should be the beginning or the end of the debate on fiscal autonomy.
171. The Scottish Government's position on independence has been clearly set-out. I believe passionately that the economic downturn demonstrates the need for Scotland to have the economic muscle and financial powers to combat recession – the need for Scotland to have the powers of a normal government are now even more acute. That is a case we are very confident to take to the people of Scotland. Just as we said we would, this Government remains committed to presenting a Bill to Parliament next year to enable Scotland's people to have a say in their own constitutional future.

Options for Reform

172. We have recently set out the options for economic reform in our report Fiscal Autonomy for Scotland, the case for change and options for reform.
173. Unlike other reviews of Scotland's financial future, this report considers all the options for reform. From maintaining the current framework through to full fiscal autonomy in an independent Scotland. Each option is assessed to judge how it could contribute to increasing sustainable economic growth in Scotland. And we are putting forward a practical and principled case for our own preferred option.
174. The most recent Government Expenditure and Revenue Scotland study, covering 2006-07 (a relatively benign year), showed that including a geographic share of oil and gas revenues, Scotland's current budget balance is not only stronger than the overall UK position, but is actually in surplus by 0.7% of GDP.

Alternative Options for Reform

175. Clearly there are a number of other options for reform other than full independence and in the spirit of a Government acting without a majority we have created the conditions for a substantial debate about where we go as a country on this question.
176. These options cover the complete range of possible reforms.

177. At one end of the spectrum is the option of continuing with the current framework – with the majority of the Scottish budget financed through a block grant.
178. An alternative would be a system of assigned revenues. This would link the Scottish Government budget directly to the tax revenue collected in Scotland – although control over tax rates and policy would remain with the UK Government.
179. Similarly, with an enhanced devolution settlement the Scottish Government could be granted control over certain taxes whilst others would still be controlled by the UK Government. Alternatively a system of tax sharing could allow the Scottish and UK Governments to split the revenue raised in Scotland.
180. Finally, under devolution max, Scotland could be granted full fiscal autonomy whilst remaining part of the UK. This would make the Scottish Government responsible for raising and collecting all tax revenue in Scotland and with only limited financial and economic policy set for the UK as a whole.
181. However, under all of these options there would be constraints on the Scottish Government’s ability to tailor policy to meet the ambitions of Scotland’s citizens and businesses.
182. Under the current economic framework the principal tax, regulatory and economic tools are reserved to the UK Government. This constrains our ability to use the full range of policies to deliver improved growth. I don’t think this is the right position for Scotland today.
183. Neither is assigned revenues. Such a system would primarily represent a change in accounting rules, not any real autonomy for Scotland.
184. Assigned revenues would not provide the Scottish Parliament with any new economic tools. The key policy levers would remain centralised at Westminster. It is little more than Barnett but with greater volatility.
185. Indeed, I believe that assigned revenues would leave Scotland worse off. It would create the appearance of responsibility without any real additional economic levers. This option is simply not credible.
186. While options granting the Scottish Parliament greater fiscal powers, such as movement towards devolution max, would represent a step-forward in devolution – only independence would give us the full range of economic levers to deliver increased sustainable economic growth.
187. Independence is the natural state for nations like Scotland. With greater responsibility for its own affairs and fiscal framework, Scotland could move from a position of relative underperformance and match, and even surpass, the success of other small European nations.

188. For example, whilst we have reduced business rates for thousands of companies, independence would enable us to introduce a more competitive corporation tax regime.
189. Research by the Economic Research Institute of Northern Ireland has shown that if Northern Ireland aligned its corporation tax rate with the rate in the Republic it would ultimately create 180,000 jobs and double the country's growth rate.
190. It is undeniable that a more competitive corporation tax system would bring similar benefits to Scotland.
191. Independence would also grant us control of one of our largest resources, North Sea oil. Energy remains of vital strategic importance – and this will grow in the future. There are between 16 and 25 billion barrels of oil equivalent remaining off our shores.

Conclusion

192. Ultimately it is only through independence that Scotland can achieve its full potential. It is only with this freedom that we will have the ability to meet and overcome the great challenges of our time.
193. So in closing let me thank you for coming here this evening.
194. Thank you for being a part of this national conversation.