SCOTTISH TRENDS

(Press Release - 28 June 2016)

Analysis of key economic and fiscal issues impacting on potential 2nd Scottish independence referendum

Key points

- **Scotland's potential future fiscal balance position has worsened since the 1st referendum in November 2014, due to the disappearance of North Sea tax revenues in the intervening period. It is now projected to remain over £9 billion by the time the UK has come into balance in 2019-20.**

- **Post Brexit, Scotland's preferred currency option is highly unlikely to be to remain part of sterling. An independent currency may be preferable or even joining the euro.**

- **Despite these two seemingly negative movements in the economic and fiscal position of an independent Scotland, support for independence may still be stronger than before, due to i) political considerations with respect to remaining in the EU and the prospect of a more right wing Tory led UK government, and ii) the electorates widespread dismissal of the advice of economic 'experts' in both of the recent referendums.**

Background

With the UK as a whole having narrowly voted to leave the EU, while Scotland voted convincingly to remain within the EU, the stage is set for a rerun of the economic and fiscal arguments that were a big part of the 1st referendum.

This note updates and re-examines some of the key economic and fiscal issues that dominated the 1st referendum to see how things have moved on since then.

Scotland's Fiscal Balance (see also Tables 1 and 2)

- Scotland's overall (i.e. including a geographical share of North Sea oil revenues) fiscal balance has worsened in recent years (to 2014-15, the latest year for which official data is available from the Scottish Government publication 'Government Expenditure and Revenues Scotland' (GERS)) even though the UK's has steadily improved.;
- This is as a result of a decline in North Sea revenues, which fell from almost £10 billion in 2011-12 to zero in 2015-16;
- When the UK's fiscal position is projected to have returned to balance in 2019-20, Scotland is projected to still be in deficit by over £9 billion.
- The Scottish Government's latest North Sea tax projections (from August 2015) use a variety of scenarios, which results in future annual revenues ranging up to £2.8 billion by 2019-20. However, this figure assumes an oil price of $100 a barrel. A more realistic alternative scenario

might involve a price of $75 a barrel (vs the current price of near $50), which it is estimated would lead to £1.7 billion of oil revenues by 2019-20. Hence, even using the Scottish Government's more optimistic future oil scenarios results in a Scottish deficit of over £6 billion in 2019-20.

- A Scottish fiscal deficit of around £9 billion (near to 5% of GDP) roughly equates to the UK's fiscal position as recently as 2014-15, so clearly such a position is manageable, although that does not mean it is an easy place to be, as on-going austerity shows.
- Scotland's fiscal position is complicated by what the net cost would be of staying in the EU. The settlement would be subject to negotiation, but given that Scotland is a relatively wealthy member (and by some measures is wealthier than the UK, as the Scottish Government is keen to highlight) then a deal as a net contributor seems likely. Hence, the ultimate settlement is unlikely to lead to a diminution of the the funding challenge facing any independent Scotland's first government.
- Based on the above analysis, moving to a position of fiscal balance would require substantial tax rises or spending cuts. This may be do-able, but the, largely unexplored, question remains - how?

How might such a deficit be managed?

Tax rises

It is possible to change tax rates without introducing serious distortions relative to the rest of the UK. It would make most sense to concentrate on the big yielders, like income tax and VAT, and on taxes that are difficult to avoid paying.

- Each 1p rise in **Scottish Income Tax** is estimated to raise just over £500 million in 2018-19. So 3p on the basic rate, with perhaps 5p on higher rates, should be able to raise well over £1.5 billion.
- If existing **VAT** exemptions (and reductions) were removed then such tax receipts could grow by over 25%. This is a policy change approved of by many economists, including James Mirrlees, now a member of the Scottish Government's Council of Economic Advisers. The negative impact on lower income households could be offset by the redistribution of some of the money raised (about £2.5 billion). Net, this could still allow for well over £1 billion extra revenue to be made available.
- Other options exist. At the Scottish election this year the RISE party proposed a new **Whisky Tax** that could raise up to an additional £1 billion a year. While not exactly mainstream the proposal is not an outlandish one. For example, Professor John Kay (ex member of the Scottish Government's Council of Economic Advisers and the person that the then First Minister, Alex Salmond, had lined up to be the leader of a Scottish Central Bank in the event of a Yes vote for independence) has previously given public support to the idea.

Spending cuts

It would be possible to cut public spending without affecting key public services like health and education. For example:

- At present Scotland's share of **Defence** spending is just over £3 billion. An 'unarmed' approach to Defence might reduce this to around £0.5 billion, proportionately in line with other very low spend countries like Iceland, Ireland and Luxembourg.
- Other potential areas for cuts include **Economic Development** (mainly Scottish Enterprise) where Scotland spends disproportionately more than the rest of the UK and, as with Defence, any cuts would have little immediate impact on citizens lives via a reduction in vital public services.

<u>Borrowing</u>

- If the Scottish Government decided to pursue a current fiscal balance rather than an overall fiscal balance (in other words balance day-to-day spending with tax revenues, but allow for borrowing to cover investment spending) this would allow for a £3 billion overall deficit. Such a policy could be justified on the grounds that, if well judged, such investment in the likes of infrastructure projects should improve future growth and will benefit multiple generations.

<u>Overall</u>

With some combination of higher taxes, lower spending and any remaining shortfall being made up by continued borrowing, a new equilibrium position might be reached in a manageable way that does not lead to a dramatically different country.

The political challenge that remains is for pro independence parties to illustrate this themselves, something that, by and large, they studiously avoided at the time of the 1st referendum.

Scotland's currency

- In the 1st Referendum of 2014 much was made of the currency that might be used post independence. While the main thrust of the organised independence supporters argument was to retain sterling, the position was less clear amongst economists.
- Few commentators supported joining the euro in the event of independence but there was much support for the idea of an independent currency. In part, this was due to the importance of a commodity, oil, to the Scottish economy. This argument has since been weakened by the decline in oil but the wider benefits of a separate currency remain valid.
- The argument for joining the euro is also stronger now. With many economists predicting economic woes post Brexit, then sterling may not be the safest place to hitch your wagon. While the euro also has its on-going, unresolved, difficulties it may turn out to be a more reliable and stable currency than sterling.
- The argument for <u>not</u> remaining in a sterling zone should be easier to make now, with Scotland being part of the EU economic union rather then the UK economic union in the future.
- It may well be that the euro becomes the preferred choice, due to the ease of transition and the inheritance of a track record and the benefit of being part of such a large currency zone.
- However, the final choice may well depend on what happens to the euro and sterling (as a proxy for a separate Scottish currency) in the intervening period up to any 2nd referendum.

Scottish Economic Growth Rate

It seems highly likely that pro independence political parties will claim a higher economic growth path in the event of independence and anti independence ones will claim a lower growth path in any future campaign.

Both claims will probably be exaggerated and largely dismissed by the electorate, probably with some justification.

On the pro side, the Scottish government is likely to claim an independence boost due to better policies being put in place. However, this seems far fetched given the lack of change to UK policies that have occurred in light of existing economic policy tools, particularly in relation to Income Tax powers. Equally, there no longer appears to be any great difference in terms of Corporation Tax policy between the two governments.

On the anti side, the UK government may well recycle the numerous and voluminous documents based on standard economic theory and modelling exercises, that show a negative impact from independence. However, these are likely, yet again, to be read by almost no-one and so may to gain little traction with voters.

Nevertheless, this is an important issue as even small annual differences in the growth rate, when compounded over time, can turn into significant impacts in terms of growth and revenues raised.

The key variable in this economic growth debate is likely to be the impact of trade. Would Scotland lose more by staying in the EU but not in the UK or by staying in the UK but not in the EU? (Of course gains are technically possible as well but the debate seems more likely to be couched in these negative terms.) This is an impossible question to answer at present, as it will depend on the trade deals that emerge in light of the decision made, which is unknowable prior to the referendum vote.

As discussed below, it will take a new style of debate by politicians and economic experts in order to impact more strongly on the voters in a 2nd referendum and in a way that they have failed to in the past two referendums.

With some elements of the independence movement accepting that there were weaknesses in the economic argument put forward at the time of the 1st referendum it will be interesting to see what adjustments are made in order to quell voters doubts.

Equally, with the UK government's economic arguments in two consecutive referendums having been largely ignored, despite being more in line with economic think tanks and organisations analysis, they may well also have to rethink their approach.

Influence of economic issues on the Referendum

With respect to economic and financial matters one of the lessons that can be taken from the EU referendum is that over half the voting electorate rejected the (strong and certain) arguments of not only all the main UK wide political parties and party leaders, save for UKIP and Nigel Farage, but also of ‘expert’ opinion in general. The latter tended to support the general line of the ‘No’ and the ‘Remain’ sides claims and their analysis was often used by these sides.

For example, analysis of ORB polling found that Remains lead in terms of which side would “create a stronger economy for the UK” narrowed over time, with fewer people believing that Brexit would result in a weaker economy for the UK by the end of campaign than at the start (although Yougov found a widening gap to a similar question). Certainly the avalanche of evidence pointing to financial losses as a result of Brexit did not lead to the expected impact on the polls.

Such widespread dismissal of warnings of financial and economic negatives also happened in relation to the 1st independence referendum in 2014. This dismissal applied not just to government analysis by the Treasury and by the Bank of England but also to independent bodies like the IFS, IMF and many others.

Once may have been a fluke but twice is more worrying. As a result, one of the key legacies of recent referendums is - how do you analyse complicated economic choices in a way that is compelling for a sceptical electorate? How does the IFS, the OECD or whoever, put forward a case that highlights both the certainties and the uncertainties, the relative likelihoods and the Black Swan events to allow for voters to make an informed decision, rather than see them rejecting the brow beating implications of the ‘your being stupid if you don't follow our advice’ exhortations of the experts? And how do bodies like the BBC then report it?

A starting point would be to admit more openly to the uncertainty of outcomes, especially where one off events are concerned. Economic models are built to replicate economies operating in fairly standard conditions, they do not work well in crises or in exceptional circumstances. By overstating the certainty of results, think tanks undermine their own reputations. The electorate, having gone through some torrid times of late, none of which were forecast by the ‘expert’ bodies, are loathe to believe that these same bodies are suddenly infallible and accurate, especially in highly unusual circumstances.

Another key change would be to stop pretending that there are decisive ‘facts’ that can help simply decide what the right answer is. It is not reasonable for the public to keep asking - “I just want to know the facts” - because that level of simplicity rarely, if ever, exists in relation to any complex political question.

If progress is not made then we may end up more like the USA, where Donald Trump has tapped into similar disbelief and dissatisfaction with both politicians and ‘experts’ and manages to dismiss any awkward analysis as irrelevant or biased.

In conclusion

If a 2nd referendum on Scottish independence is to take place then there are big challenges to be faced by:

- politicians, in terms of presenting more ‘realistic’ outcomes rather than ‘extreme’ outcome which the electorate largely ignore;
- pollsters, in terms of setting the mood and potentially influencing the turnout on each side;

- experts, including economic commentators, in terms of separating 'likely' short term effects, based on current known data, from highly uncertain longer term effects, based on unreliable modelling.

On the last point, what might emerge in a 2nd referendum on independence is an acknowledgement that a period of adjustment would be needed, in terms of the Scottish Government's budget, involving some tough decisions on tax and spend choices. However, in the longer run it may be possible for a new Scotland, similar in its tax and spend structure to many other existing OECD countries, to emerge. Overall, there might be a step change involved but not necessarily a big change in lifestyle or in Scotland's economic and fiscal structure.

For whatever reason we may not get to the point where another referendum on Scottish independence is held. However, the points made in the previous section with regards to the reputation and influence of economists and other 'experts' will remain valid and still needs to be addressed.

Quotes

"This analysis highlights the changes in economic circumstances since the 1st Scottish independence referendum. In particular, the seeming demise of the North Sea as a source of tax revenue and a Brexit vote in the UK that puts the validity of a post independence sterling zone in doubt.

However, the pull of these two apparent negatives to the success of a YES vote in another referendum may not be enough to overcome the push of the UK's decision to leave the EU and the prospect of a right of centre UK government for some time to come.

Furthermore, any new offer of independence will be put to the electorate after a brief taste, sweet or bitter, of what leaving the EU is like and this may well have a significant affect on the outcome."

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Table 1: Fiscal balance out-turns, Scotland and the UK, 2010-11 to 2014-15, £ billion

	2010-11	2011-12	2012-13	2013-14	2014-15	*(average)*
SCOTLAND						
Onshore revenues	45.5	47.2	48.3	50.1	51.6	
- share of UK revenues	*8.1%*	*8.1%*	*8.1%*	*8.1%*	*8.0%*	*(8.1%)*
Expenditure	65.7	66.1	67.7	67.5	68.4	
- share of UK expenditure	*9.3%*	*9.3%*	*9.4%*	*9.3%*	*9.3%*	*(9.3%)*
Onshore fiscal balance	-20.2	-18.9	-19.5	-17.4	-16.7	
North Sea revenues	7.5	9.6	5.3	4	1.8	*5.6*
- share of UK Total	*89%*	*88%*	*85%*	*84%*	*80%*	*(85%)*
Overall fiscal balance	-12.7	-9.2	-14.2	-13.4	-14.9	
UK overall fiscal balance	-135	-114	-120	-101	-89	
Fiscal balance, £ per head						
Scotland	-2,434	-1,745	-2,669	-2,521	-2,792	
UK	-2,147	-1,794	-1,877	-1,574	-1,379	
Scotland - UK	-287	49	-792	-947	-1,413	*-678*
Cumulative Difference, £,bn	-1.5	0.3	-4.2	-5.0	-7.6	*-3.6*

Sources: GERS 2016; authors calculations
Note: ‘Cumulative Difference’ equates to the per head differential cumulated over the entire population.

Table 2: Fiscal balance projections, Scotland and the UK, 2015-16 to 2020-21, £ billion

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	*(average)*
SCOTLAND							
Onshore revenues	55.2	58.1	60.5	63.2	66.6	69.1	
- share of UK revenues	*8.1%*	*8.1%*	*8.1%*	*8.1%*	*8.1%*	*8.1%*	*(8.1%)*
Expenditure	70.1	71.8	73.0	74.5	75.4	78.2	
- share of UK expenditure	*9.3%*	*9.3%*	*9.3%*	*9.3%*	*9.3%*	*9.3%*	*(9.3%)*
Onshore fiscal balance	-14.9	-13.7	-12.5	-11.3	-8.8	-9.1	
North Sea revenues	0	0	0	0	0	0	*0*
- share of UK Total	*85%*	*85%*	*85%*	*85%*	*85%*	*85%*	*(85%)*
Overall fiscal balance	-14.9	-13.7	-12.5	-11.3	-8.8	-9.1	
UK overall fiscal balance	-72	-56	-39	-21	10	11	
Fiscal balance, £ per head							
Scotland	-2,778	-2,543	-2,316	-2,088	-1,624	-1,679	
UK	-1,108	-845	-588	-323	157	165	
Scotland - UK	-1,670	-1698	-1728	-1765	-1781	-1844	*-1,748*
Cumulative Difference, £,bn	-9.0	-9.1	-9.3	-9.6	-9.7	-10.0	*-9.5*

Sources: OBR (Economic and Fiscal Outlook, March 2016); authors calculations

Notes:

(1) 'Cumulative Difference' equates to the per head differential cumulated over the entire population;

(2) Scottish Onshore and North Sea Revenues and Expenditure totals are derived by applying the average Scottish share over the 5 year GERS period to the UK totals.

(3) Post 2015-16, North Sea revenues for the UK are forecast by the OBR to be negative, due to issues concerning decommissioning and carry back of trading losses. However, as the impact of these issues is complicated with regards to a Scotland/UK split it has been assumed above that Scottish revenues will only fall to zero.