SCOTTISH TRENDS

(Briefing Note - Immediate Release - 15th March 2017)

Analysis of key economic and fiscal issues impacting on a 2nd Scottish independence referendum - UPDATE

In light of the announcement by the Scottish Government of its wish to hold a second referendum on Scottish independence in late 2108 or early 2019, this Briefing Note has been updated to take on board the latest (GERS and UK Budget) data, as well any any other pertinent facts.

Key points

- **Scotland's potential future fiscal balance position has worsened since the 1st referendum in November 2014, due to the virtual disappearance of North Sea tax revenues in the intervening period.**
- **Scotland's fiscal position is now projected to remain around £11 billion (-6.4% of GDP) in deficit by the time the UK has come close to balance in 2019-20 (-1% of GDP). The difference is equivalent to around £1,700 per person.**
- **Unlike past (relative) downturns, this differential is unlikely to change much under current tax and spend patterns as neither the Scottish nor the UK government's expect North Sea revenues to return to anything like past peaks.**
- **Options are available, in terms of both tax and spending plans, that would allow for an independent Scotland to close this gap. however, none of these are easy or without consequences.**
- **As a part of the EU, but not of the UK, Scotland's preferred currency option is less likely to be to remain part of sterling. An independent currency may be preferable or even joining the euro.**
- **Scotland's economy has suffered a worrying slowdown post the first independence referendum, which, if it were to continue, could also impact on voting intentions.**
- **As with Brexit, the economic implications of independence are highly uncertain, but downsides dominate. However, unlike with Brexit, instead of an initial boost to the UK's fiscal position, independence will result in Scotland experiencing a worsening of its position.**
- **Despite these 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.**
- **While difficult decisions will need to be taken, a post independence outcome for Scotland that is not unlike other western european countries could emerge. The question remains which ones would it resemble?**

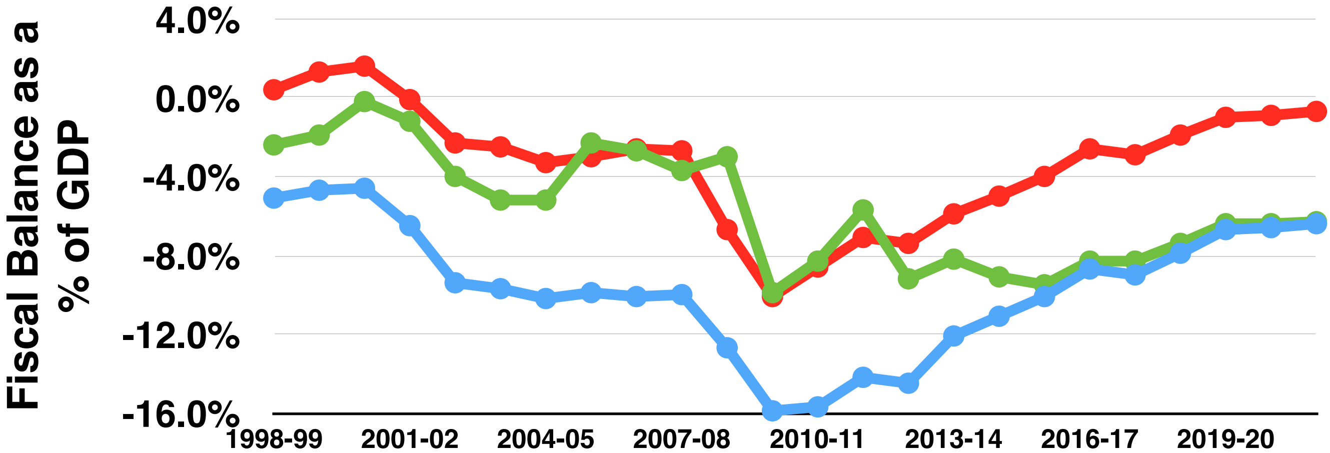
Background

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 now 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 Chart 1 and Tables in Annex 1)

- Scotland's overall (i.e. including a geographical share of North Sea oil revenues) fiscal balance has worsened post 2011-12 even though the UK's has steadily improved (see Chart 1). This is as a result of a decline in North Sea revenues, which fell from almost £10 billion in 2011-12 to effectively zero in 2015-16;
- In 2019-20, Scotland is projected to still be in deficit by almost £11 billion, which is similar to the projected deficit for the UK (£21 billion). However, in more comparable terms, as a % of GDP, this equates to over 6% of GDP for Scotland vs 1% for the UK. Such a differential is equivalent to around £1,700 per person.
- 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 (assuming an oil price of $100 a barrel) by 2019-20. However, even the Scottish Government's most optimistic future oil scenario still results in a Scottish deficit of around £9 billion.
- A Scottish fiscal deficit of around £11 billion (near to 6% of GDP) roughly equates to the UK's fiscal position as recently as 2013-14, 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 then a deal as a net contributor seems likely and so would not lead to a diminution of the the funding challenge facing an independent Scotland.
- 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?

Chart 1: Scottish and UK fiscal balances as a% of GDP, 1998-99 to 2021-22



Sources: GERS August to 2015-16; authors calculations based on OBR EFO March 2017.

How might such a deficit be managed?

Tax rises

It may be possible to change tax rates without introducing serious distortions relative to the rest of the UK. In doing so, 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 more on higher rates, should be able to raise over £1.5 billion.
- If existing **VAT** exemptions and reductions were removed then such tax receipts could grow by over 25% (based on the Mirrlees Review - 'Tax by Design' - note: James Mirrlees is 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 (around £2.5 billion), still allowing for 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.
- Negotiation over Scotland's share of UK debt may allow for a reduction in the current £2.8 billion of annual Scottish debt interest payments. This could be associated with negotiations over Trident and UK overseas assets and protectorates. (Note: discussion of the sharing of assets, liabilities and debt is a big and complex issues and is not covered in any detail here.)

Borrowing

- 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 £2-3 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.

- However, any such borrowing still involves funding associated interest payments, which is a relatively worse off position than within the UK where debt would be falling rather than rising.

Overall

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 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 in the long run. 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.

The argument for not 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.

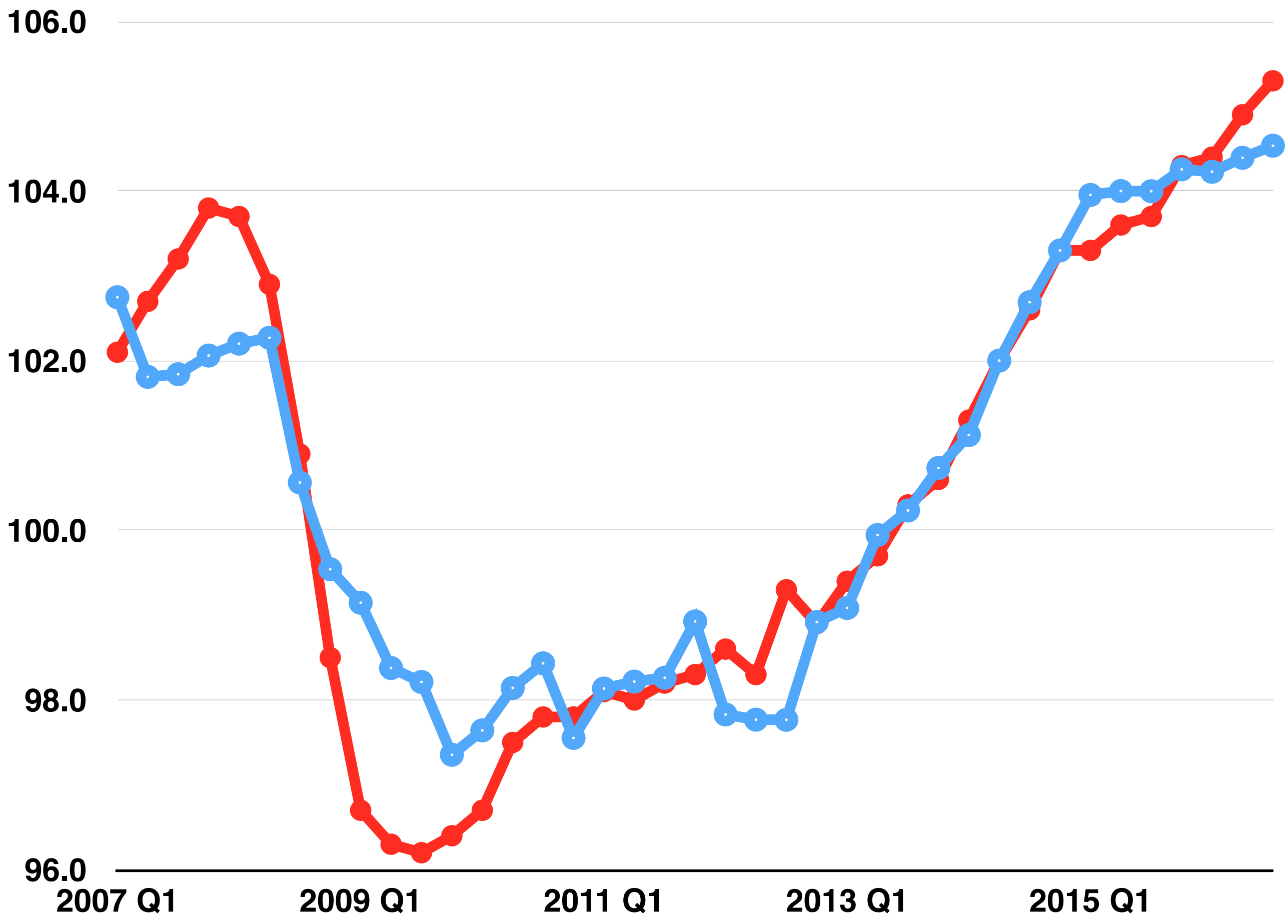
However, the final choice may well depend on what happens to the euro and sterling (as a proxy for a separate Scottish currency) in the intervening period up to the 2nd referendum.

Scottish Economic Growth Rate

Since the first independence referendum the Scottish economy has notably under performed relative to the UK economy. Chart 2 shows this slowdown stretching back to just after the last referendum.

Over the last year (of available data) the Scottish economy has grown by 0.7% while the UK economy has grown by 2.4%. This is partly down to North Sea activity falling but other factors may also be at work. To be in such an economically weak position does not bode well for the YES campaign over the coming debate and this may be exacerbated if it affects Scottish spending levels in light of the new retained income tax power.

Chart 2: Scottish and UK GDP per capita, 2007 Q1 to 2016 Q3



Source: Scottish Government, January 2017

In more general terms, 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 remain largely unread and so 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 on 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, as yet uncertain, trade deals that emerge.

As discussed below, it will take a new style of debate by politicians and economists in this area 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.

One element of the last debate that is likely to be missing is the contention that Scottish GDP per capita is higher than in the UK. This was always a spurious comparison given the high non-Scottish ownership of companies operating in the North Sea, energy, drink, financial sector etc, but it has been rendered invalid anyway due to the fall in offshore GDP and the convergence of the Scottish level to that of the UK.

BREXIT vs Independence

It is interesting to compare some of the economic and fiscal arguments that surround these two referendums.

On the economic growth side:

- both situations are similarly mired in uncertainty due to the unique nature of the events;
- the impact on trade is likely to be a key issue;
- however, it will be difficult for either side to say, post Brexit and post independence, that the impact on trade of disassociating from one economic bloc will be very different to that from another (i.e the UK out-with the EU vs Scotland out-with the UK).

On the fiscal side:

- the short-term positions are clearer and go in opposite directions;
- the impact of leaving the EU would initially improve the UK's fiscal position;
- the impact of leaving the UK would worsen the Scotland's fiscal position.

However, the wider lessons from Brexit and the first independence referendum may have more to do with public perceptions and how to effectively influence them.

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 the vast majority of 'expert' opinion. The latter tended to support the general line of the 'No' and the 'Remain' sides claims and their analysis was often used by them.

Analysis of ORB polling found that, in terms of which side would "create a stronger economy for the UK", 'Remain's lead 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 related analysis by the Treasury and the Bank of England but also to analysis by independent bodies like the IFS, IMF and many others.

Rejecting the advice of 'so-called experts' 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 etc, 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 does the media then report it?

A starting point would be to admit more openly to the uncertainty over 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 <u>not</u> 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.

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.

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 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.

Such an 'easy transition' scenario still needs to flesh out the details and admit to the tough decisions that will need to be made.

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 might entail and this may well have a significant affect on the final outcome."

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Annex 1

Table 1: Fiscal balance out-turns, Scotland and the UK, 2011-12 to 2015-16, £ billion

	2011-12	2012-13	2013-14	2014-15	2015-16	*(average)*
SCOTLAND						
Onshore revenues	47.3	48.2	50.1	51.8	53.7	
- share of UK revenues	*8.0%*	*8.0%*	*8.0%*	*7.9%*	*7.9%*	*(7.96%)*
Expenditure	65.8	67.5	67.0	67.9	68.6	
- share of UK expenditure	*9.2%*	*9.2%*	*9.1%*	*9.1%*	*9.1%*	*(9.14%)*
Onshore fiscal balance	-18.5	-19.3	-16.9	-16.1	-14.9	
North Sea revenues	9.6	5.3	4.0	1.8	0.1	*4.2*
- share of UK Total	*88%*	*85%*	*84%*	*80%*	*79%*	*84%*
Overall fiscal balance	-8.9	-14.0	-12.9	-14.3	-14.8	
- as a % of GDP	**-5.7**	**-9.2**	**-8.2**	**-9.1**	**-9.5**	
UK overall fiscal balance	-116	-123	-104	-92	-75	
- as a % of GDP	**-7.1%**	**-7.3%**	**-5.9%**	**-5.0%**	**-4.0%**	
Fiscal balance, £ per head						
Scotland	-1,659	-2,632	-2,434	-2,673	-2,760	
UK	-1,823	-1,931	-1,618	-1,416	-1,155	
Scotland - UK	**164**	**-701**	**-816**	**-1,257**	**-1,605**	*-843*
Cumulative Difference £,bn	0.9	-3.7	-4.4	-6.7	-8.6	*-4.5*

Sources: GERS August 2016; authors calculations
Notes:
(1) 'Cumulative Difference' equates to the per head differential cumulated over the entire population.
(2) In places, the latest GERS figures (from August 2016) differ slightly from those published in the 2017 UK Budget (March 2017).

Table 2: Fiscal balance projections, Scotland and the UK, 2016-17 to 2021-22, £ billion

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	*(average)*
SCOTLAND							
Onshore revenues	57.4	59.2	61.8	64.2	66.4	69.2	
- share of UK revenues	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*(7.96%)*
Expenditure	70.6	73.3	74.7	75.7	78.2	81.0	
- share of UK expenditure	*9.1%*	*9.1%*	*9.1%*	*9.1%*	*9.1%*	*9.1%*	*(9.14%)*
Onshore fiscal balance	-13.2	-14.1	-12.9	-11.5	-11.8	-11.8	
North Sea revenues	0.1	0.7	0.7	0.8	0.8	0.7	*0.6*
- share of UK Total	*80%*	*80%*	*80%*	*80%*	*80%*	*80%*	*(80%)*
Overall fiscal balance	-13.1	-13.4	-12.2	-10.7	-11.0	-11.1	
- as a % of GDP	**-8.3%**	**-8.3%**	**-7.4%**	**-6.4%**	**-6.4%**	**-6.3%**	
UK overall fiscal balance	-52	-58	-41	-21	-21	-17	
- as a % of GDP	**-2.6%**	**-2.9%**	**-1.9%**	**-1.0%**	**-0.9%**	**-0.7%**	
Fiscal balance, £ per head							
Scotland	-2,443	-2,481	-2,256	-1,972	-2,014	-2,023	
UK	-787	-869	-601	-305	-292	-234	
Scotland - UK	**-1656**	**-1612**	**-1655**	**-1667**	**-1722**	**-1789**	*-1,684*
Cumulative Difference £,bn	-8.9	-8.7	-9.0	-9.1	-9.4	-9.8	*-9.2*

Sources: OBR (Economic and Fiscal Outlook, March 2017); authors calculations

Notes:

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

(2) Scottish Onshore Revenues and Expenditure totals are derived by applying the average Scottish share over the 5 year GERS period to the UK totals. For North Sea Revenues the more recent share is used, consistent with a lower oil price.

(3) The above figures are based on Scottish tax and spend patterns continuing to be in line with those forecast (by the OBR) for the UK at the time of the 2017 UK Budget. Clearly the fiscal position could change if this were no longer the case, but, at present, no radical shifts have been proposed.