SCOTTISH TRENDS

# Reflections on the SNP's Sustainable Growth Commission Report

The recent Sustainable Growth Commission Report has sparked renewed debate over the economics and public finances of an independent Scotland. This briefing note looks at some of the main issues involved and puts forward some alternative proposals.

## Key points of the report

- The **main strengths** of the report include: support for an open immigration policy; widening the debate on currency options; sensible assumptions over the treatment of North Sea oil revenues; and accepting mutual ownership of existing UK assets and liabilities, including national debt.
- The **main weaknesses** of the report include: a lack of transparency over the implications of future spending restrictions; no analysis of the negative implications of break-in up the UK free trade area; a lack of clarity over Scotland's future debt position; and a potentially over optimistic approach to both start up costs and the assignment of UK assets.
- **In particular**, with respect to the tight spending settlements proposed, the report ignores the impact that rising health needs and other pressures will have on unprotected budgets. Meeting such needs would require real terms cuts of over 15% in the rest (50%) of the budget in the decade post independence. This scenario seems unsustainable given the cuts already imposed on many of these 'unprotected' budgets.
- In order to avoid the need for much of this extended austerity, **alternative ways by which the fiscal deficit might be addressed at the point of independence are proposed here**.
- **On the spending side** these include: reducing Defence spending to a level similar to that seen in low spending European countries; reducing other areas of public spending (e.g. economic support) which are currently well above the UK average; and rationalising existing spending patterns in terms of both levels and uprating.
- **On the revenues side** these include: potential increases in income tax and the removal of VAT exemptions; introducing new taxes (e.g. on whisky); and increasing some service charges, in line with working examples in other countries.
- Some of the **key conclusions** are:
    - on **economic growth,** slower rather than faster growth may occur in the short to medium term, for the same reason (weaker trade links) that UK growth may be hampered by Brexit;
    - on the **fiscal balance**, a way needs to be found to reduce the inherited deficit to a more manageable level. This may be better achieved through a series of upfront tax and spend adjustments, rather than through another decade of relative austerity;
    - on **currency,** arguments over whether some form of 'sterlingisation', a separate currency or joining the euro remain unresolved;
    - on changing **tax and spend patterns**, this is best achieved at the point of independence.

## Introduction

The recent Sustainable Growth Commission Report (SGCR) for the SNP ('Scotland - the new case for optimism', see https://www.sustainablegrowthcommission.scot/report ) offers a way forward from the 2013 White Paper proposals, in terms of policies concerning economic growth, the fiscal balance and currency.

At 354 pages long the SGCR inevitably has points where the reader will disagree with the findings. In doing so any critic needs to set out clearly why they disagree and to signal an alternative way forward. Hopefully this contribution does that.

The remainder of this note looks at:

1. the main strengths of the report;
2. the main weaknesses of the report;
3. spending and revenue related options with respect to how to reduce the inherited fiscal deficit;
4. conclusions.

(Note: I should acknowledge up front my contribution to the SGCR. In late 2016 I was commissioned to provide a background paper on the Scottish Balance of Payments (not published but available at Scottish Trends, see http://scottishtrends.co.uk/wp-content/uploads/2018/05/SNP-Growth-Commission-on-BoP-revised-May2018-II.pdf ). That said, this briefing note is not a defence of the report, as I had no hand in what was finally published. )

## Main Strengths

**1) Treatment of North Sea Oil revenues**

At this stage of the North Sea's development it is right to delegate its, small and erratic, fiscal contribution to the status of a 'bonus' to be saved up and used to fund inter-generational investment opportunities. As the most recent Scottish Government analysis showed, even a return to $100 a barrel is likely to result in less than £3 billion of revenues, a far cry from the near £9 billion figure seen as recently as 2011.

**2) Migration Policy**

A more open immigration policy should prove beneficial to Scottish economic prospects, in comparison to the likely UK alternative. These benefits will apply in the case of both skilled and less skilled (e.g. in relation to the tourist industry, agriculture, adult social care related) immigrants.

**3) Currency options beyond sterling**

While 'sharing' sterling was the policy position of the SNP at the time of the last referendum, the SGCR also looks at the merits of Scotland creating its own currency. Furthermore, where it considers continuing with sterling it does so in terms of a form of 'sterlingisation' (i.e. an unofficial tracking of one country's currency by another country) as opposed to the unenforceable 'sharing' of sterling that the SNP proposed in 2014.

**4) Acceptance of population based sharing of UK debt**

In contrast to some discussion at the time of the last referendum - where it was proposed to adjust the Scottish share of UK debt for past, North Sea related, fiscal surpluses, or even for accepting no responsibility at all - the SGCR recommends that Scotland accepts its population share of UK debt.

**5) Use of 'conservative' growth assumptions when considering the fiscal position**

When attempting to calculate Scotland's future fiscal balance the SGCR wisely foregoes assuming that Scottish GDP growth will be boosted by independence. Instead it uses an average of recent, relatively low, GDP growth rates when forecasting future revenues. Given the degree of uncertainty associated with improving the rate of growth of productivity, this is clearly the most appropriate way to proceed.

**6) Widening of responsibility for identifying future economic policy**

While some commentators have criticised the number of new committees and advisory councils that the SGCR recommends setting up, these are probably necessary. This is because little is currently available on the workings and weaknesses of the Scottish economy as there are so few think tanks and academics active in this area.

## Main Weaknesses

**1) Lack of transparency over future spending choices**

The SGCR omits any analysis of how different public service budgets will vary post independence, concentrating instead on a 0.5%, real terms, annual increase in overall expenditure. This means that the implications of significant spending related pressures over the 10 year transition period are avoided. Including such trends can affect the disaggregated picture considerably.

For example:

- Health spending (around 20% of the total budget) is anticipated to require real terms increases of around 4% a year for at least the next 15 years (see IFS/Health Foundation analysis, May 2018);
- similar spending pressures may also apply with respect to Adult Social Care;
- there will be new, and rising, debt interest payments. Even at the SGCR's assumed interest rate of 2.3%, these payments could account for around half of the 0.5% annual real terms increase;
- the Social Protection budget (which includes pensions, benefits etc and accounts for around 30% of the total budget) is likely to rise by at least 1% above inflation (i.e in line with RPI rather than CPI), given past trends.

As a result, the SGCR's average 0.5% real terms annual increase in spending seems likely to result in the 50% of the budget that is not protected in some way (which includes four of the Scottish Governments current priority spending areas) experiencing real terms cuts of over 1.5% a year, or a cumulative cut of over 15%. How realistic this would be after a period where many of these spending areas have already experienced cuts of a similar or higher magnitude is debatable. Instead tax increases or the targeting of specific spending areas, like overseas related spend, may be needed.

**2) Lack of clarity over Scotland's debt level**

The SGCR only considers the build up of new debt when calculating the debt position of an independent Scotland and in constructing a debt target. However, implicit in the £5.3 billion 'annual solidarity payment' to the UK Government is an 'adjusted' £3 billion in debt servicing charges (see point 6 below on the veracity of such an adjustment).

Post independence, potential purchasers of new Scottish debt will inevitably consider Scotland's underlying fiscal position including both inherited and new debt. Hence, it would be more transparent if the Commission estimated the joint (old and new) debt position. If this were done, the debt as a share of GDP figure would be notably higher than the 50% target for new debt and so a revised, total debt, target should also be set.

**3) The set up and on-going costs of independence**

These have been estimated by a team from the London School of Economics (LSE) at £450 million, with potential for them to be offset by on-going efficiency savings. Past estimates have varied quite widely and the final figures will depend on the degree of co-operation between governments during negotiations around the time of independence. The LSE analysis also implies that on-going costs would be close to zero, indeed, once new jobs related revenues are taken into account the fiscal balance improves.

However, the analysis in the SGCR must remain tentative for now. For example, the minimal 55 country spread of embassies (assuming that each embassy is stand alone rather than representing a network of consulates within each country) is only 5 more than the the number of diplomatic missions that the UK currently has in just seven countries (USA, India, Spain, China, Brazil, Nigeria and Australia). Clearly then the coverage available abroad post independence could be severely curtailed, or there will be further costs for agreeing some form of shared use of UK missions. Another example is the UK's Office of National Statistics, which is not mentioned in the report but where staff levels are around 3,300, with limited prospects for savings if the same quality and breadth of data is intended. (Note that the provision of a much expanded range of economic data (e.g. Balance of Payments, inflation etc) will be an vital consequence of independence.)

Furthermore, intuitively, it seems likely that the loss of economies of scale would lead to some increase in on-going running costs, post independence. The validity of the the LSE's findings will be easier to gauge once the research has been published. However, it seems likely that more work will still needed in this area.

**4) Further currency options and details**

It is disappointing that the option of joining the euro is barely mentioned in the report. An advantage of joining the euro is that there is less of a need to build up a reputation and foreign currency reserves as part of the shared EU central banking system. While the euro's prospects looked poor around the time of the Greek crisis, they now look much stronger, although basic flaws in the design still exist. One such flaw, the sharing of a currency and monetary policy framework without a shared fiscal policy framework, can also be seen in any 'sterlingisation' model post independence. As a result, there is notable support amongst a number of economists for a separate Scottish currency at the point of independence, whereas business interests are more sympathetic to the continued use of some form of sterling.

At this stage an open mind needs to be kept as to what the best currency option might be, acknowledging that this option may change in the fast moving and febrile economic environment that continues to exist post the 2008 global financial crisis. The SGCR may have been better off softening up public and political opinion to allow for a wider debate on this subject rather than making a straight choice now.

**5) Lack of analysis of the negative implications of breaking up the UK free trade area**

The economic arguments against the UK's leaving the EU single market mirror those that would apply if Scotland left the UK single market. As such they cannot simply be ignored, as the SGCR largely does. The Scottish Governments own calculations of the impact of Brexit suggests that Scottish GDP would be 8.5% lower by 2030, based on a relatively 'soft', WTO rules, scenario. The impact of Scotland leaving the UK could be greater or smaller than this, depending, as with Brexit, on what the terms of dis-engagement involve. Greater analysis of the implications of different post-independence UK trade options is badly needed.

**6) Analysis of the distribution of UK Assets and Liabilities**

The SGCR assumes that Scotland's share of the UK non-current assets is £26 billion above its population share and proposes that this 'excess' should be used to reduce Scotland's inherited debt share, rather than to improve Scotland's asset base or be put into a sovereign wealth fund. Issues like the treatment of UK (largely english) student debt and nuclear and North Sea decommissioning costs highlight how difficult it is to be certain of the size of inherited shares at this stage. As a result, it would be more prudent to simply accept a population share for now. Doing so has ramifications for the size of inherited debt and for the fiscal balance, where the debt interest element of the annual solidarity payment would rise from £3 billion to £3.75 billion.

## Alternatives with respect to how to reduce the inherited fiscal deficit

In contemplating how to address Scotland's inherited fiscal deficit, the SGCR largely ignores looking at where and how the inherited tax and spend patterns might be changed, preferring instead to leave this to post independence comprehensive reviews. However, such an approach severely constrains choices over how the inherited fiscal deficit might be addressed and how decade long tight spending settlements, and fast rising debt levels, might be avoided. As an alternative, the following analysis looks at some options for making immediate changes to inherited spending and revenue levels.

### 1) Spending reduction options

- **Defence**

At present Scotland spends around 2% of GDP (£3 billion in 2016-17), while the SGCR recommends a reduction to 1.6%. However, an even deeper cut would be in line with what countries like Austria, Ireland and Switzerland currently spend, equivalent to 0.7% of GDP or less. Such cuts also have the advantage that much of Defence spend relates to purchases from overseas and involves jobs that are not currently based in Scotland.

- **Areas of disproportionately high spend**

Scotland currently spends disproportionately more in a number of areas, in particular in relation to economic development (e.g. Scottish Enterprise), in comparison to the rest of the UK (see Annex 1 for details). Some cuts to this relative overspending may be deemed worthwhile. Other such areas of interest in this context include public administration and recreation.

- **Rationalising existing spending patterns**

Over time inefficient spending patterns can emerge and become entrenched. For example, the first year of a Scottish university degree can duplicate much of the work that students do when undertaking Advanced Highers. Restructuring could save money and such rationalisation could go further, introducing intensive 2-3 year courses or 2-3 year courses in areas where a 4 year course is not essential.

Another example would be uprating charges and benefits by the correct measure of inflation. Currently many benefits are updated for inflation based on the RPI measure. However, the methodology used to calculate RPI is known to be faulty resulting in its being consistently around 1 percentage point higher than the more accurate CPI. Use of the lower measure would save money, particularly when compounded over time.

**Overall on public spending,** the options highlighted above above have the potential to save at least £3 billion.

### 2) Revenue raising options

When considering revenue raising options it is important to look at the impact of any changes to the whole package of taxes, as opposed to the impact that changing a single tax might have. This allows for greater scope with respect to what might be viable without introducing negative behavioural and incentives impacts, especially relative to the rest of the UK. For example, considerable differences in individual tax rates between Northern Ireland and Ireland, between Denmark and Germany and even within Spain, without undue pressures emerging.

- **Income Tax and VAT**

A 1p rise in Scottish **Income Tax** is currently estimated to raise around £500 million in 2018-19. However, in order to raise such sums the increase needs to apply across all tax bands, not just for higher earners, where such targeting would result in the gains being much reduced.

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' - James Mirrlees being an ex 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.

- **New or Varied Taxes**

A variety of new taxes might be introduced, including: some form of tourism tax; taxes which are proportionate to wealth/income rather than flat, as happens for example in some Scandinavian countries in relation to traffic fines; more local government control of tax powers; a form of land tax. Some of these would be new taxes and some are more likely to replace existing taxes, such as property tax in the case of land tax.

As an example, a new Whisky Tax might prove attractive as it is not possible for manufacturers to move production elsewhere if they still want to call it Scotch whisky. Also, current high profit levels may mean that much of the cost of any new tax is absorbed by producers rather than feeding through to consumers and to potentially lower output through substitution effects.

- **Increased Service charges**

There are a number of areas where existing service charges are relatively low by international standards and which might be increased based on examples in other countries which do not appear to lead to undue problems. For example, in Ireland citizens are required to pay a subsidised fee for a variety of basic health care activities, dependent on income and other factors.

**Overall on sources of government revenue**, the options highlighted above have the potential to improve government finances by at least another £3 billion.

## 3) Net impact

Taken together the revenue gains and spending cuts outlined above suggest that at least £6 billion of the pre independence fiscal deficit could be eradicated, equivalent to over 3% of GDP. This would result in a shift from an inherited position of a deficit of 7.1% of GDP to one of under 4% of GDP, not far from the SGCR's (3%) target after 10 years of relative austerity. Such a shift would therefore avoid the need for such a tight post independence spending settlement.

This approach is in sharp contrast with the SGCR's approach, where the initial cut in inherited spending involves only a small reduction in Defence (-0.4% of GDP), a debatable swapping of assets for debt reduction (-0.4% of GDP) and an equally debatable small saving on 'UK' related spending out with Scotland (-0.3% of GDP). The remainder of the 1.6% of GDP reduction in the deficit in 2020-21 comes from an, again questionable, increase in revenues (+0.5% of GDP) through what were 'UK' based jobs on behalf of Scotland, moving to Scotland post independence.

## Conclusions

Analysis of the SGCR highlights a number of important points in relation to the economics and public finances of Scottish independence. The key ones are:

### 1) On Growth

Both risks and opportunities apply to post Scottish independence economic growth rates. In the short to medium term, as with Brexit and the UK economy, the risks are likely to dominate the opportunities. However, in the longer term they may be more balanced. As such, any notion that Scotland's economic performance will automatically, or even probably, improve as a result of independence is a hope rather than an expectation based on hard evidence.

### 2) On the Fiscal Position

The existing fiscal set up within the UK sees Scotland enjoy greater spending per head than the UK average while revenues raised per head fall just short of the UK average (excluding North Sea revenues). As a result, Scotland is the beneficiary of a net fiscal transfer from the rest of the UK. This is hardly surprising given that Scotland amounts to third of the land mass of the UK, including a series of islands, whereas it has less than 10% of the population. Such geographic factors inevitably increase the cost of delivering most types of public services, not just in areas like transport. However, outside of the UK this cross subsidisation inevitably disappears and so an alternative source of funding needs to be found for the, roughly £10 billion, transfer that will be lost. Either that or some of the existing level of services needs to be curtailed.

This briefing note has dwelt on how the inherited fiscal deficit might be better dealt with. Instead of a gradual process over a decade, which necessitates on-going cuts in around 50% of public services, the approach outlined here emphasises a significant reduction at the point of independence. The alternative, a real terms decline of over 15% in non health and social protection budgets in the first decade of independence, does not seem like a good way of starting out. In addition, it seems more likely that radical changes to tax and spending patterns would be possible at the point of independence rather than in the years following independence, by which time inherited patterns may have become entrenched.

Furthermore, significant doubts remain over what the impact may be on the fiscal position from: the need to build up currency reserves, regardless of the currency choice; the inherited debt position and associated debt servicing costs; and the start-up costs and any on-going costs or savings.

### 3) On Currency

The choice of a form of 'sterlingisation' in the SGCR seems premature at this stage. There is a valid case, put forward by a number of economists, for choosing a separate currency as the best way to proceed. This is particularly true if the SNP believes that monetary, and to some extent fiscal, policy as set by the UK government will continue to be anathema to Scotland. Equally, if continuing membership of the EU is thought to be a good idea then serious consideration needs to be given to joining the euro. Overall, this subject needs to be further debated, including the implications of the final choice on economic and fiscal stability and autonomy.

Overall, the Sustainable Growth Commission report has successfully moved the debate forward but it has by no means settled all the arguments, nor does it claim to have. Some thorny problems remain as well as ones where the best course of action is either prone to change with economic conditions or will never be clear and obvious.

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## Annex 1: Relative spending levels across the UK

Table 1 below looks at the latest figures available for how spending per head levels vary, by different functions, across the four nations of the UK.

**Table 1: Relative spend, £ per head of population, across the UK by function, 2017-18**

| | UK | Scotland | England | Wales | N Ireland |
|---|---|---|---|---|---|
| **Public Services** | 119 | **201** | 106 | 164 | 187 |
| **Law & Order** | 431 | 478 | 420 | 404 | **655** |
| **Economic Affairs** | 700 | **1,097** | 653 | 741 | 849 |
| *- agriculture* | *80* | ***188*** | *59* | *149* | ***271*** |
| *- economic dev* | *91* | ***174*** | *77* | *125* | ***180*** |
| *- transport* | *435* | ***620*** | *425* | *377* | *307* |
| **Environment** | 164 | **249** | 155 | 200 | 138 |
| **Housing** | 159 | **327** | 130 | 230 | **411** |
| **Health** | 2,187 | 2,332 | 2,169 | 2,233 | 2,240 |
| **Culture & Recr'n** | 115 | **195** | 100 | 154 | **252** |
| **Education** | 1,329 | **1,512** | 1,306 | 1,345 | 1,459 |
| **Social Protect'n** | 3,955 | 4,260 | 3,859 | **4,605** | **4,851** |
| **Total** | 9,159 | **10,651,** | 8,898 | 10,076 | **11,042** |

Source: HM Treasury, PESA 2018

For some functions - such as the Environment, Transport and Agriculture - the relatively high levels of spend for Scotland seen in Table 1 can be put down to geographic causes. For others, like public administration, the differences may be due to structural causes, for example a separate Scottish Parliament and 32 local councils. Yet others, like housing and cultural activities, will be policy driven.