SCOTTISH TRENDS

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Potential impact of Brexit analysis and negotiations on any second Scottish independence referendum

What lessons does Brexit hold for a second referendum on Scottish independence? This briefing note looks at the degree to which (i) the economic and (ii) the fiscal impacts are symmetrical between the UK leaving the EU and Scotland leaving the UK and (iii) what lessons might be learnt from the Brexit negotiation process.

Main findings:

1) with respect to **economic growth**: the Brexit related arguments that the break up of an economic and customs union will result in a negative impact on future economic growth - due to increased tariff and non-tariff barriers - are also valid in the case of Scottish independence from the UK economic union. However, the degree to which this impact might be greater or lesser than for Brexit remains a matter for debate;

2) with respect to any **fiscal transfer**: it is widely accepted that Scotland will be deprived of a net transfer - in the region of £10 billion - from the rest of the UK in the event of independence. This is in contrast to the UK leaving the EU, where the immediate impact is likely to be positive (although negative once longer term, slower growth, impacts are incorporated);

3) with respect to the **final independence arrangement**: as has emerged through the Brexit discussions, a vote in favour Scottish independence is likely to lead to a plethora of options for what 'independence' might consist of. These range from an old style nation-state to remaining in some form of political and economic union with both the EU and the UK. A bespoke arrangement with both bodies seems likely to result in the most advantageous (or least detrimental) outcome in economic terms. This might involve i) membership of the EEA, similar to Norway, and ii) a form of 'British Union', similar in form to the current EU in terms of being an area of shared political sovereignty and economic co-operation amongst its member nation states. Such a 'British Union' might allow for the use of sterling, no trade barriers and some degree of continuing fiscal transfer;

4) while, as with Brexit, the first (economic impact) of these changes to the political and economic landscape around a second referendum may have little influence on the electorate, the second (fiscal impact) is more likely to affect, negatively, voting intentions. This in turn may make it more likely that an alternative form of independence is proposed which helps ameliorate some of these impacts.

The economic and fiscal impacts of independence

Economic Growth

One of the near universal findings around Brexit is that any deal would produce a worse economic out-turn than the status quo position, both in the short and in the long term. This is due to a combination of higher trade barriers and poorer productivity prospects.

Such a finding is similar to the forecasts made of the impact of dissolving the UK economic union at the time of the First Scottish Independence Referendum in 2014. However, on that occasion the Scottish Government, as led by the SNP, largely discounted such findings. This position has changed for any Second Scottish Independence Referendum due to:

- the commonly acknowledged impact of the breaking up of a closely knit economic union during discussions around Brexit;
- the SNP's recognition of the negative effects associated with breaking up the European economic union;
- the introduction of a new, independent, Scottish Fiscal Commission, which is likely to produce economic forecasts for Scotland that are in line with those made by the IFS and others at the time of the first referendum.

Despite the general consensus over the negative impacts of dismantling an economic and/or customs union, there will still be claims and counterclaims over whether any such negative impacts would be 'larger' or 'smaller' than those outlined with regards to Brexit.

For example, on the 'larger impact than Brexit' side, opponents of independence might point to:

- even closer economic ties between Scotland and the UK than between the UK and the EU. (Note: Scottish exports to the rest of the UK accounted for 61% of all exports in 2016 (EU 17%) while UK exports to the EU in 2016 accounted for 43% (nearer 50% if exports to Scotland are included).)

On the 'smaller impact than Brexit' side, proponents of independence might point to:

- the mutual benefits of a 'soft' form of economic independence;
- retaining sterling and close links with the Bank of England;
- an absence of any border controls,;
- the ability of an economically independent Scotland to prosper though achieving faster productivity growth, as outlined in the SNP's Growth Commission report.

However, objections can be made to such claims, for example, with respect to:

- on the absence of border controls - the Scottish Government could find that the EU will still want a say as may the UK Government, e.g. with regards to the issue of freedom of movement;
- on productivity gains - in the absence of any clear and unequivocal policies to improve productivity, which themselves can be difficult to identify and/or gain political support for, then productivity driven growth gains remains more of an aspiration than a likely outcome.

Given that most economic models are based on standard economic theory backed up by empirical findings then forecasting bodies will continue to predict an economic downside to independence, due to the introduction of greater trading barriers and slower productivity growth. However, the academic nature of such forecasts, and variation in forecast results, may leave the electorate unconvinced on the matter, as appears to have happened with regards to Brexit.

The issue of **currency** in any post independence scenario will remain a thorny one. If the UK leaves the EU and Scotland stays in, then the idea of using sterling seems far-fetched, as this would mean participating in an economic union with one body (the EU) while at the same time participating in a currency union with a different body (the UK). This would be especially difficult if the UK increasingly diverged from the EU in terms of its fiscal and monetary policies. At the very least it would be an ugly fit.

Fiscal Position

One key area of difference between Scottish independence and Brexit is that no 'official' claim is likely to be made that leaving the UK would result in any fiscal benefit for Scotland.

Such a claim could be made in the case of Brexit, due to the net transfer of funds to the EU from the UK, even if most forecasters predicted that any such gain would ultimately be lost as a result of slower economic growth over time.

In the case of Scotland leaving the UK, and in the absence of any radical turnaround in the fortunes of the North Sea, an independent Scotland would lose out, due to the ending of a net transfer of funds from the UK to Scotland. This position, largely obfuscated in the White Paper of 2013 through a forecast of sustained high oil tax revenues, is now widely recognised due to:

- recent GERS publications reflecting the low oil tax position;
- the latest (2015) Scottish Government forecast of future oil and gas tax revenues;
- the SNP's Growth Commission reports analysis of the inherited fiscal position of a newly independent Scotland;
- all independent analysis of the position at the time of the FSIR and since.

It is also important to note that the scale of this shortfall is considerable. Most analysis, including the SNP's Growth Commission report, acknowledge that it would be worth in the region of £10 billion, possibly higher.

Furthermore, in contrast to the vaguer forecasts of slower future economic growth, predictions of the fiscal loss are more robust. Hence, the impact on Scotland's tax and spend position and policies becomes a much more immediate and urgent task to address and possibly more influential on voters thinking.

The economic and political shape of independence

As the Brexit negotiations have shown, the idea of true political and economic 'independence' in the modern age is largely an illusion. The reality is much more likely to be some form of shared sovereignty. It is a moot point whether countries within the EU are better referred to as member states of a quasi-federal, central, Parliament or as nation states who share some forms of economic and political co-operation.

Hence in the same sense that 'Brexit means Brexit' is a meaningless statement (without defining Brexit), then so too would 'Independence means Independence' be. That being so, it has been very useful for the post Brexit vote discussion to highlight the multitude of options available for what Brexit could ultimately look like. We now know that any vote for Scottish independence could result in a similar 'rainbow' of potential outcomes being proposed and supported by a minority of voters or politicians.

(Note: in the case of the first referendum what was being voted on was clearer. The White Paper (2013) outlined in some detail, the hoped for outcome. But even here negotiation would have been inevitable, over nuclear weapons, debt, currency, assets and liabilities, the North Sea, etc, etc.)

What are the options?

Some of the clearer potential options for Scotland are:

1. No change: staying within the UK;
2. UK federalism : being within an enhanced federal UK;
3. European Union: being outside the UK but within the EU;
4. EEA/EFTA: within the Single Market and/or customs union(s) (i.e. Norway/Switzerland style arrangement);
5. Bespoke arrangement with both the UK and the EU;
6. Independence: outside both the UK and the EU.

When seen in this light then a future Scotland - UK relationship becomes much more flexible.

Assuming that the UK does leave the EU, while also acknowledging that it may still be part of the single market and/or the customs union, then the optimal position for Scotland may well be a bespoke arrangement with both the EU and with the UK.

With respect to the EU, this might involve membership of the EEA (as Norway has) which would in turn allow Scotland to:

- stay in the Single Market;
- leave the CAP and the CFP;
- allow for some degree of freedom with respect to negotiating trade agreements with third countries (i.e. attempting to keep a barrier free relationship with the UK).

With respect to the UK, this might involve:

- using sterling as Scotland's currency (which seems much more likely than if Scotland were still a member of the EU);
- a sharing of other potentially expensive public sector services, including Defence and some forms of foreign affairs (e.g. embassies);
- some continuing fiscal transfer to Scotland, dependent on the degree of on-going co-operation;
- retaining a fully free trading and open border arrangement, although possibly with some restrictions being applied given the EU freedom of movement commitment associated with being in the EEA.

In the event that such a 'British Union' - more along current EU lines than current UK lines - came about then clearly England, due to its size, would dominate it, and to a much greater extent than Germany does the EU. However, if unequal positions of influence can be deemed as acceptable in the EU, given the side benefits to the smaller countries, then presumably they could equally well be accommodated in a British Union.

Any such arrangement could allow for a degree of freedom within common 'British Union' fiscal and monetary positions. Equally, with respect to areas like Defence and Foreign Affairs, some type of 'opt-out' option could exist where views differ on specific actions.

The major stumbling block at present is the absence of an English Parliament.

The above scenario highlights just one variant that might emerge. Indeed, both the SNP's Growth Commissions 'annual solidarity payment' and the Scottish Government's own proposal for a differentiated Brexit solution for Scotland (see 'Scotland's Place in Europe', 2016) could be said to be exploring such new territory.

Summary and Conclusions

This analysis has highlighted the following key differences between a second Scottish Independence referendum and the first:

Economic implications

On the pro-leave side, Scotland could negotiate a stronger relationship with the EU market than if it remained in the UK.

On the pro-remain side would be the, widely acknowledged, negative implications of breaking up a strong economic and customs union (the UK);

Fiscal implications

Unlike Brexit, where any potential net fiscal loss from the UK leaving the EU is disputed and relatively minor, Scottish independence would result in a widely recognised significant fiscal loss, of the order of £10 billion.

The loss of this current transfer of public funds from the rest of the UK to Scotland will require immediate attention, involving raising taxes and/or on-going constraints on public spending;

Options for 'independence'

Given the greater scrutiny that Brexit has brought with respect to claims of how simple and costless it is to leave a close economic union, then a second referendum might throw up a range of possible 'independence' outcomes.

Some of these 'bespoke' variations could potentially offer considerable relief from much of the negative economic and fiscal pressures outlined above, while at the same time notably expanding the sovereignty of the Scottish Government.

How might these three differences to the political and economic landscape affect voting intentions in a second referendum? Recent polling suggests little in the way of a change of heart amongst the Scottish electorate post Brexit but voting patterns may change as minds become more concentrated leading up to any second referendum. Looking at each difference from before in turn:

- it is possible that the first (economic impact) will gain little traction with the public, as appears to be the case with the first independence referendum and Brexit;
- the second (fiscal impact) may be more influential, especially as the SNP's Growth Commission accepts that there will be a five to ten year transition period post independence when public spending growth will need to be constrained;
- the third (post independence arrangement) may be influenced by any emerging negativity relating to the second. A different model of independence may be sought in attempting to avoid a significant fiscal loss and continuing strong economic and social ties. This might lead to a 'British Union' that exhibits a level footing in terms of nationhood but which may still be skewed in terms of effective economic and political power.

How long might it take for both sides to come to accept some new form of independence? That is very difficult to judge. In normal times it might seem a stretch to see a radical shift in stance in a short period of time. However, these are far from normal times and the current febrile political environment makes such radical change seem more possible.

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