SCOTTISH TRENDS

GERS, COVID and SCOTTISH INDEPENDENCE

(revisiting economic and fiscal arguments around a Second Independence Referendum)

Introduction

The publication of the latest Government Expenditure and Revenue Scotland (GERS) report provides an opportunity to revisit some of the key economic and fiscal (i.e. public finances position) arguments around Scottish independence, including what impact COVID-19 might have.

The analysis below highlights:

- a worsening of Scotland's Fiscal Balance position since the First Independence Referendum, due to much lower North Sea revenues and poorer growth in its onshore revenues, relative to the UK;
- the uncertainties and changes in mindset that COVID-19 might bring about;
- the merits of proposing a higher tax 'fiscal adjustment process', as opposed to a decade of spending constraint;
- the merits of proposing a new economic model, incorporating higher taxes, as opposed to a limited variant on the UK model;
- the lack of leadership within the SNP in developing and popularising a post independence economic model.

GERS 2020

The 2020 edition of GERS confirms that in 2019-20, i.e. prior to COVID-19, tax revenues in Scotland stood at around 37% of GDP, compared to public spending at 46% of GDP, leaving a 9% differential. By contrast the UK differential stood at around 3%. This higher Scottish differential (worth 6% of GDP) is equivalent to around £11 billion and is, in effect, the net fiscal benefit from Scotland's being part of the UK's shared public finances system. This equates to around 14% of total public sector spending in Scotland.

In the years prior to 2014-15, due to highly variable North Sea revenues, this 'net transfer' figure could vary significantly year-by-year and sometimes result in Scotland gaining, in fiscal terms, from independence. However, especially since the oil price collapse over the second half of 2014, such variability has largely disappeared and oil related revenues are widely predicted to remain low.

Due to pandemic related uncertainty over future tax and spend estimates no forecasts have been included in this analysis for Scotland's fiscal balance beyond 2019-20. However, the £11 billion net loss of funding figure is likely to remain germane to any future debate on independence.

COVID-19

2019-2020 will be the last financial year for some time where fiscal balance figures are available that are not severely distorted by COVID-19 affected tax and spend patterns. For example, UK debt as a % of GDP had, by July 2020, risen above 100%, while the fiscal deficit for 2020-21 is expected to be over 16% of GDP, rather than the 2.6% seen in 2019-20.

At present it is impossible to judge how the pandemic may change the pattern of public spending or what fiscal rules might apply. However, such impacts may well be extensive.

Examples of how the pandemic is likely to affect countries views on their economic future and their approach to public finances include:

- a shift from economic efficiency to economic resilience, with less emphasis on just in time and more on just in case;
- higher levels of taxes, spending and public debt;
- building greater slack into public service provision (e.g. health and education);
- changes to trade links and supply chains;
- a move to a more environmentally friendly growth model;
- reducing income and workers rights inequalities;
- economic and physical protection for 'essential' and 'frontline' workers;
- increased levels of preventative health and care home spending.

Such changes greatly enhance the scope for a variety of new economic models to be put forward as the basis for how any post independence Scottish economy and public finance targets would work.

An updated Independence prospectus

Economic and fiscal changes since 2014, together with the current pandemic, will impact significantly on relevant arguments around a Second Referendum. In particular, Scotland's fiscal position and its choice of economic model need to be re-appraised.

1) The Fiscal Position

Changes in Scotland's fiscal position since the First Referendum

Scotland's fiscal position has altered since the First Independence Referendum for three reasons.

First, due to the UK Government's policy of bringing the UK fiscal budget back into balance then Scotland's absolute deficit has also fallen. However, this has had little impact on the net loss to public funding from Scottish independence.

Second, Scotland's fiscal balance relative to the UK has worsened due to a fall in revenues from the North Sea. At the time of the First Independence Referendum the latest out-turn data for Scottish oil revenues was £4.6 billion (2012-13). The White Paper estimated future revenues of between £6.8 and £7.9 billion for 2016-17, well above the out-turn figure of £0.2 billion. The latest out-turn figure, for 2019-20, is £0.7 billion and the latest OBR forecasts (March 2020) for UK North Sea revenues are at or below £1 billion for every financial year up to 2024-25.

Third, Scotland's fiscal balance relative to the UK has worsened due to an apparent one-off fall in Scotland's share of earnings related revenues (relating to Income Tax and National Insurance

Contributions) between 2014-15 and 2015-16. In those years, the UK garnered £9 billion more tax revenue from these two sources. Scotland's proportional population share would have been around £740 million but instead there was a recorded fall of £140 million. It is not clear why this anomaly arose. It could have been related to a disproportionate loss of earnings relating to offshore workers, although to be so concentrated in one tax year would be unusual. There may also have been some independence referendum related impact from wealthier Scottish taxpayers rearranging their affairs in order to register in England rather than in Scotland. Either way, the Scottish/UK differential in onshore tax paid per head rose from around £-120 (average over 2011-12 to 2014-15) to more than £-400 (2015-16) and remains at this higher level in 2019-20 (£-431).

Where do these changes leave Scotland with respect to its post independence fiscal position?

Net funding position

It is widely accepted that Scotland currently receives a net transfer of funds from the UK. However, as recently as 2011-12 any such transfer would have been negligible, due to large offshore revenues. In recent years the transfer is thought to be approaching £11 billion (see Appendix for details). Since North Sea revenues are not expected to significantly recover from recent, low, levels then a loss of this scale can currently also be expected at the time of any Second Referendum.

The (SNP commissioned) Sustainable Growth Commission Report (SGCR) largely acknowledged the scale of this transfer (although the details differed from the calculations shown in the Appendix) as too have bodies like the Institute for Fiscal Studies.

The key question then, and one not addressed at the time of the last White Paper, is how to make such an adjustment.

Spending constraint adjustment

The SGCR's principal proposal for dealing with this situation was that there should be a decade long transition period to allow the Scottish fiscal deficit to be brought down to a more manageable level of below 3% of GDP. *(Note: this does not adjust for the full extent of the fiscal transfer, it is simply the adjustment made to reach a 'sustainable' fiscal position.)*

The SGCR suggested that this could be achieved while still allowing for an annual 0.5%, real terms, growth in overall public funding (i.e. 1% below the assumed annual real terms GDP growth rate of 1.5% but 0.5% above the assumed annual inflation rate of 2%). There are a few important points to note about what an annual 0.5%, real terms, increase in public spending adjustment mechanism means:

- if Health pressures grow at 3-5% above inflation (as predicted by IFS and others) and Social Security payments grow in line with RPI or wages, then all other public service budgets (50% of the total) would see annual cuts of around -1% for a decade;
- the Scottish Fiscal Commission expect future Scottish GDP growth to be less than 1.5% and so the 0.5% figure may be on the optimistic side;
- an annual 0.5% public spending growth figure is lower than that seen in UK public spending over the 'austerity' years, 2013-14 to 2019-20;
- the 0.5% growth figure is well below the, pre COVID-19, 1.25% average growth rate forecast for total public spending growth at the UK level up to 2023-24.

The above observations suggest that such a public spending scenario - of on-going austerity for most public services - seems unlikely to be a popular one and may not be politically sustainable. *(Note: In the event that Scotland reentered the EU, it remains unclear whether the speed and extent of adjustment set out in the SGCR would satisfy EU fiscal rules.)*

Tax raising adjustment

An alternative adjustment route, to raise taxes, could do away with the need for such a difficult and prolonged adjustment phase. This approach is at odds with the one taken in both the last White Paper and in the SGCR, i.e. that taxes do not need to rise in an independent Scotland. However, given the SGCR's acceptance of the existence of a significant (negative) net fiscal transfer, as well as the evidence of higher tax raising levels in other small independent countries (see discussion of Table 1 below), then raising taxes at the point of independence may ultimately be a more politically fruitful way forward than attempting to restrain public spending for another decade.

A further reason to raise taxes at the point of independence relates to the arguments made below on what type of growth a post-independence Scotland is looking for. If there is to be a greater emphasis on well-being or on the environment then higher taxes may be needed. For example, taking on Scotland's poor life expectancy may require a step change in early years investment and mental health spending. Such an approach may involve even larger increases in taxes than simply needed to replace the existing UK transfer, unless significant cuts were made in other areas e.g. Defence.

The debate over which taxes should be raised and on what their distributional impact should be is clearly important but is not discussed here. It is worth noting however that the size of the adjustment suggests significant increases will be needed across a range of taxes and will require a contribution from all Scots households, not just the wealthiest. There may also be concerns over the behavioural impact of such higher tax rates. These are valid but may be overstated as significant differences already exist between neighbouring countries in Western Europe.

Scotland's fiscal position at the point of independence may end up not looking so different to that faced by many other countries post COVID-19 but that would simply hide, temporarily, an underlying problem. The existing differential between taxes and spending is not sustainable and would be looked upon with some scepticism by both the EU and by those expected to purchase government bonds in order to fund it.

2) The Economic Model

The willingness to look at a significantly different economic model to that followed in most 'advanced' economies, has been gaining ground for some time now and the pandemic will have only strengthened that appeal. Such a shift should hold attractions for pro-independence campaigners as it allows for a more unique 'Scottish' economic model to emerge. This might be seen as advantageous as, given the uncertainties and risks inherent in leaving the UK economic union then it is always going to be a difficult argument to convince voters of a 'no harm' outcome. However, by shifting the terms of the argument, by instead comparing two different economic models, such a disadvantage is, to some extent, overcome.

It is worthwhile therefore considering the economic growth model put forward by the SGCR and what alternatives might exist.

How valid is the SGCR economic model?

The SGCR outlined three small country economic growth models:

- the **Ireland/Singapore model** based on low tax, light touch regulation;
- the **Nordic model**, based on higher taxes and stronger social support mechanisms;
- the **NZ model**, based on moderate taxes and a natural resources based economy.

The SGCR then proceeds to highlight aspects of Denmark, Finland and New Zealand for its own 'Next Generation Economic Model'. However, this seems disingenuous. The first two countries are from the higher tax model and the New Zealand 'model' has only one example, New Zealand, which, with its natural resources base (e.g. in 2018, over 60% of its exports related to foodstuffs and tourism) may not be especially apposite. *(Note: The lower tax option is ruled out for a variety of reasons.)* Furthermore, other examples fit more into the higher tax, stronger social support, model, including: Netherlands; Belgium; Austria; and Iceland.

Table 1, below, highlights some of the more relevant economic, fiscal and geographical factors that are present in such small countries. While the countries included in Table 1 are not dissimilar to the list of small countries considered in the SGCR, Table 1 excludes Hong Kong and Singapore, as they are seen as exceptional with respect to their political (effectively quasi-authoritarian democracies under single party rule), geographic (extremely small and high density, around 7,000 people per sq km) and population (almost 30% of Singapores population is non-resident). In contrast, the SGCR excludes Iceland, Greece, Portugal and Luxembourg, although the latter two are included in the Scottish Government's list of small EU countries to which Scottish GDP growth is compared in its Scotland Performs set of targets. All such lists exclude ex Communist Bloc countries which are generally at a different stage of economic development.

It is also worth noting that one drawback which all such small country comparisons have is that few share the economic history of Scotland. With the exception of Belgium, no other country from Table 1 had a similar experience of being rapidly and extensively industrialised and then suffering from varying speeds of deindustrialisation that left deep and stubborn economic and social problems. Such historical factors and problems may limit the relevance of learning from other countries policies.

Nevertheless, Table 1 highlights a number of factors that appear to be typical for countries with relatively small economies, for example:

1) **Tax Revenues as a % of GDP** tends to be well above the level which currently applies to the UK (and Scotland);

2) the **Current Account** tends to be in surplus, with only New Zealand showing a significant (i.e. over 3% of GDP) deficit;

3) the governments **Fiscal Position** is near to balance or in surplus;

4) **Living Standards** (measured by real Gross Domestic Household Income per capita) tend to be relatively high.

Table 1: Small country comparison analysis statistics, 2018

Country	Population	Population density	Tax Revenue as % GDP (2)	Current Account as % GDP (3)	Fiscal Balance as % of GDP	GDHI p.c. ($,000) (4)
UK	*66*	*275*	*34*	*-4*	*-2*	*34*
Scotland	5	65	(34)	(Deficit)	-8	32
Netherlands	17	511	39	11	1	36
Belgium	11	377	45	-1	-1	36
Greece	11	83	39	-3	1	21
Portugal	10	112	35	0	0	26
Sweden	10	25	44	3	1	34
Austria	9	107	42	2	0	38
Switzerland	9	216	28	8	1	42
Denmark	6	138	45	7	0	35
Finland	6	18	43	-2	-1	35
Norway	5	15	39	7	8	40
NZ	5	19	33	-4	1	33
Ireland (1)	5	70	22/35	6	0	30
Luxembourg (1)	<1	250	40/57	5	3	47
Iceland	<1	4	37	3	1	n/a

Sources: World Bank, OECD, Scottish Government
Notes: 1) OECD data for Ireland and Luxembourg, given as a % of GDP, need to be adjusted to GNI to attain more realistic, comparable, figures. In Table 1 this is attempted for 'tax revenue as a % of GDP' only.
2) The OECD tax revenue share for the UK is different to that shown in GERS (37%), presumably due to the use of different methodologies. Scotland's share in GERS is the same as for the UK and so the same UK OECD share is used here.
3) Scotland's Current Account position is difficult to estimate given the lack of data in relation to Scotland's Current Account. However, it seems very likely, even including North Sea activity, that it is in a deficit position.
4) GDHI data for New Zealand refers to 2017.

Of course, simply observing that such common features exist across small countries is insufficient to conclude that they are likely outcomes, unless some pertinent causal factors can be identified. In this case such causal factors might include:

- smaller economies tend to be more open (i.e. have greater trade activity levels as their economies are less self contained) which typically results in a strong international balance position;
- smaller economies may be more susceptible to boom and bust than larger ones, due to being more concentrated around specific activities and so government's protect themselves by having a stronger fiscal balance position;
- smaller countries tend to lose out on economies of scale re provision of public services, especially as …
- … many smaller countries also have low population density, which can increase the need for public spend per head;
- smaller economies may feel, or be, under greater pressure to have sound fiscal and international balances in order to retain the confidence of the financial markets.

(Note: Moving to a Current Account closer to balance or in surplus would be driven by the private sector but the government could help with, for example, export supporting policies. The impact from a floating currency, presuming an independent currency rather than one closely connected to UK sterling, could also help, although this would also have knock on consequences in other areas.)

The above analysis suggests that an independent Scotland is more likely to follow a higher tax model than it is the current UK one. The SGCR avoided such a 'higher tax model' conclusion by leaning heavily on the inclusion of New Zealand as the basis of a potential alternative model. However, as Table 1 shows, it is very much an outlier amongst appropriate small country examples.

In more general terms the SGCR avoided the question of recommending what any particular 'Next Generation Economic Model' might be by seeking a "national debate" on the issue and a "cross-partisan collaborative approach". Neither eventuality seemed very likely then or now. The publication of the SGCR threw up little in the way of economic debate in Scotland or of cross partisan engagement over key issues. It seems unlikely that such a'reasoned' way of attaining a post independence model will emerge for inclusion in the next White Paper, rather one will have to emerge from the leading proponents, the SNP.

An alternative economic model?

Proposals put forward in the 2014 White Paper, and likely to merge in the next one, essentially suggest that Scotland would not diverge far from the UK economic model. The attractions of this 'continuity' model are obvious, it is easily recognisable and minimises the need for change to stable working practices, like the use of sterling. However, it has the drawback of being strongly associated with the alleged 'failed' UK economic model that Scotland needs to escape from and that has performed relatively poorly post the 2008 crisis.

While such a 'continuity' model may have been understandable at the time of the first Referendum, or even when the SGCR was being written (largely in late 2016), it is increasingly open to debate if this remains the best model to adopt now.

An alternative model could present Scotland as being a 'first-mover' that can then gain an economic advantage over other countries. Such arguments also have the upside of avoiding the 'risks of separation' threat by emphasising instead the risks of staying with an outmoded model, as opposed to moving forward to a new model.

One example of the kind of new thinking around growth involves a greater focus on reducing inequality as a way of improving well-being and the standard of living across the wider population. Economists like (Nobel Prize winners) Abhijit Banerjee & Esther Duflo ("Good Economics for Hard Times" (2019)) and Branko Milanovic ("Capitalism Alone" (2019)) highlight the economic and political drawbacks of the modern day 'liberal meritocratic capitalism'.

With respect to finding ways of growing the economy, Bannerjee & Duflo note that *"The bottom line is that despite the best efforts of generations of economists, the deep mechanisms of persistent economic growth remain elusive"*, a finding in line with the conclusions of the World Bank's Commission on Growth and Development in 2006. As a result they consider *"The most important question we can usefully answer in rich countries is not how to make them grow even richer, but how to improve the quality of life of their average citizen."*

Such an approach is reinforced by Dietrich Voller's view (see 'Fully Grown', 2019) that a slowing GDP growth rate is to be expected, given changes to the social and industrial make up of most advanced economies, and that the focus should now be on tackling the problem of distribution.

The policy implications of moving to a more widely shared/owned form of capitalism (i.e. one where growth is important but so too is its distribution) include: tax incentives or regulations to encourage a wider holding of financial assets amongst the population; higher inheritance and/or marginal tax rates for the very rich; and improved free public education, particularly with respect to pre-school education. Overall, such models seek to achieve greater equality of assets (both financial and skills based) as opposed to using redistributive policies to rein in rising inequality, the current UK position.

Another example would involve putting greater emphasis on moving to 'sustainable' or 'green' growth, although what such terms mean and how they might actually be achieved remain contentious at present. A shift from consumerism to more 'social' service based outputs/outcomes (i.e. high quality and better paid/funded nursing care, pre school care etc) is one way of looking at this, while large scale investment in more energy efficient infrastructure and means of production is another. *(Note: While the 'Sustainable Growth Commission' had the word sustainable in its title, it did not address this aspect of growth in its environmental sense. For the SGC, sustainable meant being in balance, as in a sustainable fiscal position.)*

The higher taxes proposition referred to earlier has obvious negative connotations in terms of voter appeal, but these might be more easily managed at a time of great upheaval, as now, and when the transition is to a new model and not to one more comparable with the existing UK model. However, it is difficult to make such an argument when few in the the SNP are actively involved in outlining, developing and proselytising such an alternative model.

3) Leadership

Even before the pandemic changed the ground-rules, the SNP's approach to the economics of independence was uncertain. The Sustainable Growth Commission Report (SGCR) had received lukewarm support from the party as whole and parts of it were rejected or watered down with respect to currency, the economic model and the fiscal approach.

It can be argued that this uncertainty is the result of an on-going lack of economic leadership within the SNP, post Alex Salmond, towards any new post independence economic approach. Of those who advanced the SNP's economic policy post devolution (i.e. Alex Salmond, Andrew Wilson, Jim Mather and Andrew Hughes-Hallet) only Andrew Wilson remains active, albeit at a distance given that he is no longer a politician.

The lack of Cabinet level buy-in and promotion in support of the SGCR meant that it was not difficult for unconvinced SNP rank and file to oppose it. This lack of economic engagement by senior SNP Ministers remains a weakness for the independence message on the economy. It may be that the new Finance Minister, Kate Forbes (who was a member of the 14 person Commission), assumes such a role, but there is little sign of that so far. Perhaps the Scottish Governments updated analysis papers, promised prior to the pandemic, will address these issues seriously, but this also seems unlikely. Hence, it is difficult to see who will take up the reins in directing economic policy prior to a Second Referendum.

Such a policy vacuum in a key area of the independence debate may be manageable when minds are focussed elsewhere but if a Second Referendum were to become a reality then it would soon turn into a significant weak point in the pro-independence argument.

(Note: The pro-Union supporters economic argument could also do with being strengthened compared to the First Referendum. While the UK Treasury produced voluminous, largely unread, analytical papers, there was very little senior political involvement, at either the Scottish or UK level, in championing this material.)

4) Avoiding another Brexit

In order to avoid the confusion and mis-information that dogged much of the economic debate around the First Independence Referendum and around Brexit then more trusted and authoritative channels of information need to be found. This is easier said than done and at present the lack of engagement and debate on such crucial, but complex, issues (witness the lack of reaction to the SGCR) bodes ill.

The general lack of interest and analysis in Scotland with respect to the economy - whether it be with respect to academics, journalists, think tanks or politicians - remains a concern and would have been a problem at the best of times but with a background including a recent/on-going pandemic and the early days of Brexit, then the potential for confusion and deliberate obfuscation of likely out-turns is considerable.

It is essential that the basic economic and fiscal principles and policies of any new beginning are clearly laid out and coherent. To avoid doing so, as with Brexit, is asking for trouble.

John McLaren,
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Appendix - Changes to net funding positions, how does Brexit differ from Scottish Independence?

At the time of the EU referendum there was much debate around the UK's net contribution to the EU budget. The ONS published an analysis of this (see https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/theukcontributiontotheeubudget/2017-10-31) in September 2019. It showed that, taking an average over the period 2014-2018:

UK Gross contribution = £18 billion
UK Gross receipts = £10.2 billion (£4.6 bn of abatement plus £5.6 bn of EU funding)
UK Net Contribution = £7.8 billion (i.e. around 1% of all UK public spend)

Source: European Commission
Note: It is important to take a multi-year average as the annual net contribution can vary.

What would the figures look like for Scotland leaving the UK? The GERS publication shows that for 2019-20:

Scottish Gross contribution (i.e. revenues) = £65.9 billion (inc North Sea geographic share)
Scottish Gross receipts (i.e. public expenditure) = £81 billion
Scottish Net Contribution = £-15.1 billion

Source: GERS, 2020

However, a further adjustment has to be made to this figure as the UK as a whole is running a deficit of around £55 billion, of which Scotland's population share would be £4.5 billion.

Revised Scottish Net Contribution = £-10.6 billion (i.e. around 14% of all Scottish public spending in 2019-20)

Hence, instead of a relatively small (1%) budgetary <u>benefit</u> from the UK leaving the EU, there is a relatively large (14%) budgetary <u>loss</u> from Scotland leaving the UK.

(Note: These are static, point of departure, estimates. The final fiscal gain/loss impact will also depend on i) the on-going (dynamic) economic gain/loss from Brexit or Independence, but this is very difficult to estimate in advance, ii) any negotiations with the UK Government over assets and liabilities e.g. Defence related, iii) Scotland's net EU contribution.)