The Economics of Scottish Independence

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Outline

1. A framework for assessing economics of Scottish independence

2. The big issues
   - Structural deficit
   - Oil fund prospect
   - Currency choice
   - Future competitiveness
Framework

We need information in three areas if we are to assess economic impact of independence:

• The settlement

• The constitutional counterfactual

• The nature and dimensions of economic impact
  • One – off transition costs and benefits
  • The sustained costs and benefits of being independent
Framework

The Settlement

• The detail of what the likely settlement - and variance possibilities - would be in the key areas of public finances: revenues, expenditures, assets and liabilities; institutional retention and change, including EU position

• Almost impossible to know before the event: a lot depends on the negotiations post referendum
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The Constitutional Counterfactual

• That is what constitutional alternative do we compare independence to?
  • The status-quo from new Scotland Act?
  • Devo-Plus?
  • Devo-Max?
• This is crucial because
  • Some – many? – of the possibilities of independence may be available in these alternative union arrangements.
  • Likelihood of realising these alternatives?
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The Economic Impact of Independence

Consider the economic arguments to embrace:

• static allocative efficiency issues: the what, how, for whom questions
• public finance issues, assets, debts and entitlements
• stabilisation issues
• distributional issues
• dynamic efficiency, or growth issues
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The Economic Impact of Independence

Static Efficiency

• How might independence lead to a better mix of goods and services, more efficiently produced, for those who most desire them, or not?

• Sectoral implications: e.g. Scottish energy supply and UK energy market. Loss of, change to, (UK) subsidies to Scottish renewables?

• Will the new political border serve to limit economic transactions, especially with rest of UK, where 67% of Scottish exports go?
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The Economic Impact of Independence

Static Efficiency

- Some relevant theoretical work here by e.g. Alesina and Spolaore “The Size of Nations” (2005) they argue that the optimal size of a country is determined by a cost-benefit trade-off between the benefits of size and the costs of heterogeneity.
- Size is positively related to economies of scale in government functions, or “public goods”.
- Size is negatively related to the satisfaction of local preferences for “public goods” – driven by median voter.
The Economic Impact of Independence

Static Efficiency

• So, independence likely to mean that certain functions may be more costly to deliver and/or new functions will be required: defence, foreign representation, regulation, taxation function (replacement for HMRC), vehicle excise, a Fiscal Council e.g. OBR in UK, or better CBO in USA etc.

• But, independence might better enable policies to meet Scottish preferences, or sub-groups within Scotland; Scotland less diverse than UK because smaller. e.g. local regulation might seek to promote competition more effectively in Scotland than UK regulation at present, there again it might fail to do this as well as at present.
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The Economic Impact of Independence

Framework

The Economic Impact of Independence

Public Finances

- Key implication is for control of public finances: gain fiscal autonomy but lose access to equalisation payments and “automatic stabilising” impact of these UK welfare payments.

- Gain assets and liabilities: costs of taking a share of UK debt; benefits of share in UK assets; gain of oil revenues; defence assets - fighter aircraft, ships, tanks, and other army vehicles?

- Nature, costs and savings from any shared services agreed with the rUK government e.g. DVLA, monarchy (!)

- Scottish budget constraint become “hard” - i.e. becomes binding on Scotland - under independence
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The Economic Impact of Independence

Public Finances

• GERS suggests Scotland has a structural deficit

• See next slide
Fiscal Balance as percentage of GDP Scotland and UK

Including oil production and Scotland with *population* share of oil revenues
Fiscal Balance as percentage of GDP Scotland and UK

Including oil production and Scotland with *geographic* share of oil revenues
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<tr>
<td>Geographic share oil revenues</td>
<td>1.5</td>
<td>-2.4</td>
<td>-3.6</td>
<td>-2.6</td>
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<tr>
<td>Population share oil revenues</td>
<td>-5.3</td>
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Framework

The Economic Impact of Independence

Stabilisation

• The monetary framework adopted, what’s possible and what’s best, e.g. keep pound sterling and stay in UK monetary union; seek to join the eurozone; run a separate currency: pros and cons of each?
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The Economic Impact of Independence

Stabilisation

• Fiscal policy only macro-policy instrument in monetary union: can this be used to stabilise the Scottish economy better post independence than currently? Currently rely on effect of UK stabilisation policy. UK stabilisation policy may not be appropriate economically or politically for Scotland.

• An independent Scottish government might be able to use macro-stabilisation policy to dampen growth of demand and prevent costs and prices moving out of line. If had the political will to do this it might prevent some of the problems emerging that led Scotland to rely on UK regional policy and local development policy ex post.
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The Economic Impact of Independence

Income Distribution

• Both UK and Scotland have highly unequal income distribution, worse than OECD average and much worse than Nordic countries.
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The Economic Impact of Independence

Income Distribution

Equality of household income as measured by the Gini coefficient, GB and Scotland 1994/95 - 2009/10

(Smaller figures signify greater equality)
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The Economic Impact of Independence

Income Distribution

• Independence opens up possibility of changing the tax and benefit system to alter the distribution of income.
• But this possibility available under devo-plus, and devo-max as well as independence?
• Does independence give more scope?
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The Economic Impact of Independence

Dynamic efficiency and growth

• Issue not simply how to get more growth but whether independence better allows the Scottish people to both choose their desired rate of economic growth and whether it provides the capacity to raise the rate of growth, if that is indeed desired.

• The demand-side consequences: impact, if any on product demand from domestic households, exports, tourism, investment, government spending; supply-side consequences for the drivers of productivity and growth.
The Economic Impact of Independence

Dynamic efficiency and growth

• **Supply-side gains**: any gain in supply potential affecting growth that is the consequence of independence per se?

  • Stimulation of existing activity: rise in 'animal spirits', reduced risk aversion, more investment, new firm formation, innovation etc. Reasons why this should happen?

• Attraction of new economic activities, or activities with economic consequences. Former would include companies, migrants, other organisations e.g. education. Latter would include embassies of foreign governments, or, international bodies. Any other?
Framework

The Economic Impact of Independence

Dynamic efficiency and growth

• Supply-side losses: any loss in supply potential affecting growth that is the consequence of independence per se?
  
  • Dampening of existing economic activity, fall in 'animal spirits', increased risk aversion, less investment, new firm formation, innovation etc. Reasons why this should happen?
  
  • Loss of economic activities, or other activities? Some activities may leave Scotland as a result of independence. Likely candidates would be financial service firms and pension providers who do much of their business in rUK.
Framework

The Economic Impact of Independence

Dynamic efficiency and growth

• Policy change

  • Can development policy be improved post-independence (via Scottish Development International, Scottish Enterprise and Highlands and Islands Enterprise), or will there be no difference?
  • Is there a greater likelihood of more emphasis on investment and growth than under present system or any likely devolved system? If so, why would that be so?
  • But will development policy be weaker under independence because fewer resources are available due to budget constraints, or because of heightened rent seeking in an independent Scotland?
2. The Big Issues

• The structural deficit

• Prospects for an Oil Fund

• Choice of currency

• Future competitiveness
The Big Issues

**The structural deficit**

- Hard budget constraint would force some combination of lower government expenditure and increased taxation in an attempt to reduce the deficit.

- Situation different from devolution because any increase in unemployment and total benefit payments would have to be met locally this would tend to counteract any beneficial impact on deficit of expenditure cut

- Ease of borrowing to fund budget deficits and long-term capital investment? - will depend on reputation of government, fiscal behaviour, debt level to GDP, choice of currency regime and relations hip with central bank - foreign central bank if part of sterling or euro union.
The Big Issues

Prospects for an Oil Fund

• If Scotland has a structural deficit then an oil fund is unlikely unless financed by tax increases or spending cuts.

• Volatility of oil revenues, constituting 12% of tax revenues, is a problem for planning public spending.

• Difficult to commit to long-term expenditure plans when a key source of revenue is so volatile and may be in decline.
Government Revenues from UK Oil and Gas Production (2009/10 prices)
Potential Hydrocarbon Production

$70/bbl and 40p/therm

Hurdle: Real NPV @ 10% / Devex @ 10% > 0.5
The Big Issues

Choice of currency

• The economics of optimum currency areas has relevance here, with issues such as labour and product market flexibility, capital mobility, fiscal transfers, production diversification and legal systems, being key.

• Scotland highly integrated with UK through trade and labour market flows, also current high fiscal integration, so sterling is most likely initial post-independence choice.

• But an independent Scotland will break UK fiscal links but will be subject to some fiscal control by BOE.
The Big Issues

Choice of currency

• Post independence if Scottish trade patterns shift in favour of Eurozone away from UK, if Scottish LM becomes more linked to EZ and if there is greater EZ fiscal integration, then it may be appropriate for Scotland to join Euro – if it still exists!

• But relative track of future Scottish productivity – competitiveness - is crucial if begin to diverge below EZ core then don’t go into Euro

• If productivity begins to diverge from UK improving or worsening then may be case for separate Scottish currency, allowing Scottish control of monetary policy.
The Big Issues

Future competitiveness

• The issue of Scotland’s future competitiveness is crucial both to the decision to stay in UK union and to choice of currency post independence.

• A sustained deterioration of competitiveness relative to UK would mean higher unemployment and lower income growth if part of UK union, or independent but remaining in sterling monetary union.

• But, in such a case, remaining in UK union would give Scotland potential access to UK regional policy.

• Also further tax devolution would allow Scotland to deploy fiscal policy to prevent loss of competitiveness from incipient inflation.
Future competitiveness

- An independent Scotland would probably have more fiscal powers than under devolution: therefore more fiscal options but may be borrowing constraints on fiscal policy.
- Recent Scottish productivity performance is good and productivity level is now comparable to UK, but there may be measurement issues.
- Almost impossible to say how Scotland’s future productivity growth would develop in an independent Scotland.
- In that sense independence, as in so much else, is a leap of faith.
Scottish Labour Productivity 2001-2010
UK=100

Source: ONS Labour Productivity, Q3 2011