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Financial Scrutiny Unit Briefing

Scotland's economy: future developments

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This briefing aims to assist the Economy, Energy & Tourism Committee in their inquiry into Scotland's Economic Future Post-2014. It has been produced as supplementary material to the SPICe briefing on 'Scotland's economy: recent developments' and the Scottish Government's 'Scotland's Future: Your Guide to an Independent Scotland' publication. It highlights key economic considerations for Scotland's future under different constitutional arrangements by drawing on some of the additional papers that have been published by the Scottish Government, the UK Government and the ESRC 'Future of UK and Scotland' programme to inform the debate.

The Scottish Parliament
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KEY ECONOMIC CONSIDERATIONS FOR SCOTLAND'S FUTURE

The upcoming referendum on independence has stimulated much debate surrounding the key economic considerations for Scotland's future. The Scottish Government published 'Scotland's Future: Your Guide to an Independent Scotland' in November 2013. This followed on from 'Building Security and Creating Opportunity: Economic Policy choices in an Independent Scotland' (also November 2013) setting out the Scottish Government's views on the economic levers that would be available under independence in key areas such as competitiveness, innovation, sustainability and international trade. In addition to these publications, both the Scottish Government and the UK Government are publishing a series of reports to inform the debate. The Scottish Government has also established the Fiscal Commission Working Group which is helping to shape the development of a robust fiscal and macroeconomic framework for an independent Scotland. The members are Professors Andrew Hughes Hallett, Sir Jim Mirrlees, Frances Ruane and Joseph Stiglitz and they have published four reports to date.

A number of academics and think tanks are also undertaking research to inform the debate. Of particular note is the 'Future of UK and Scotland' programme of research funded by the Economic and Social Research Council.

The next sections draw from the additional publications and provide a summary of key proposals and research findings in the following areas:

- Monetary policy
- Fiscal policy
    - Taxation
    - Public spending and the fiscal framework
    - Borrowing and debt
- Economic focus
- Welfare and equality

MONETARY POLICY

The Fiscal Commission and the Scottish Government are in agreement that, given the economic integration between Scotland and the rest of the UK, an independent Scotland would wish to continue to use the pound sterling within a monetary union. The UK Government suggests that independence will lead to a weakening of economic integration, and questions the economic rationale for the UK to agree to a monetary union. Research by the National Institute for Economic and Social Research (NIESR) suggests that there may be a case for introducing a new Scottish currency to give an independent Scotland an extra degree of policy freedom to support the financial system if necessary.

Table 1 – Key research in the area of monetary policy

Title	Published by	Overview
First Report – Macroeconomic Framework	Fiscal Commission Working Group (February 2013)	This report puts forward recommendations with regard to the macroeconomic framework (monetary policy, fiscal policy and financial stability) of an independent Scotland. For example, the Group states that, given the scale of integrated markets, the preferred model would be for Scotland to enter a formal monetary union with the rest of the UK with the Bank of England operating as central bank for the common monetary area. The Group suggests that retaining a common currency would promote the

		single market and help facilitate trade and investment to and from the rest of the UK and elsewhere. It proposes that ownership and governance of the Bank could be undertaken on an agreed shared basis and monetary policy would be set in the monetary area according to economic conditions in both Scotland and the UK. In addition, it proposed that key elements of prudential regulation should be discharged on a consistent basis across the monetary area, whereas areas of financial regulation (such as consumer protection and 'conduct' aspects) could be discharged in Scotland.
Currency Choices for an Independent Scotland	Scottish Government (April 2013)	In this paper the Scottish Government agrees with the Fiscal Commission's view that it makes sense to retain Sterling in a currency union with the rest of the UK.
Scotland analysis: Currency and monetary policy	UK Government (April 2013)	This paper looks at currency and monetary policy arrangements if Scotland was independent and states that the currency and macroeconomic framework that operates across the UK would not be able to continue. In the event of independence, institutional and policy divergence between Scotland and the continuing UK would be likely to lead to a weakening of economic integration. These effects would cause monetary policy set by the Bank of England to become less appropriate over time for an independent Scottish state's economic conditions. It raises the question of how and whether lender of last resort facilities could work in an independent Scotland. And how and why a central bank from one state, such as the Bank of England, could step in to provide financial support to the banks or financial sector of another state. For this and other reasons, the paper concludes that the economic rationale for the UK to agree to enter a formal sterling union with a separate state is not clear.
Scotland's Currency Options	Angus Armstrong and Monique Ebell, the National Institute for Economic and Social Research (September 2013)	This research looks at the three currency options for an independent Scotland: being part of a sterling currency union, adopting the euro, or having an independent currency. It takes a different approach to the Fiscal Commission and UK Government as it considers the impact of each currency option on fiscal sustainability. They find that no currency option is the best when considered against all criteria. However, the researchers conclude that the greater the amount of public debt an independent Scotland assumes, the greater the importance of retaining some policy flexibility and the stronger the case for introducing a new Scottish currency. Countries with their own currency have an extra degree of policy freedom which allows them to pursue exceptional monetary policy measures to support the financial system if necessary.

FISCAL POLICY

Taxation

Both the Institute for Fiscal Studies and the Fiscal Commission note that independence offers an opportunity to re-design the tax system in Scotland to make it simpler and more efficient. However, new challenges would arise as a result of the creation of a tax border between Scotland and the rest of the UK.

Table 2 – Key research in the area of taxation

Title	Published by	Overview
Taxing an Independent Scotland	Stuart Adam, Paul Johnson and Barra Roantree, Institute for Fiscal Studies (October 2013)	Suggests that independence offers autonomy in the design of its tax system and thus an opportunity to improve upon the current UK tax system, for example along the lines proposed in the recent IFS-led Mirrlees Review of the tax system. Differences between Scotland and the UK means that current UK tax rates might not be optimal, or the government of an independent Scotland might place more value on redistribution or public services. Independence would also bring new challenges ranging from cross-border shopping in the context of indirect taxes to tax competition in the direct tax system. Tax competition between Scotland and rUK could leave them raising less revenue than if the countries co-operated to set rates at what would be best for them collectively.
Principles for a Modern and Efficient Tax System in an Independent Scotland	Fiscal Commission Working Group (November 2013)	Suggests that independence offers an opportunity to re-examine the tax system and design one that is more robust and efficient following the principles of simplicity, neutrality, stability and flexibility. Recommendations and examples to consider include: • The use of fiscal rules and the establishment of an independent fiscal commission • The establishment of a stabilisation fund to manage natural resources and enhance economic resilience • The use of a select few targeted tax reliefs • The use of modern technology to lower the burden of administration and compliance • Linking the tax and welfare systems so the system can be used to tackle inequality effectively

Public spending and the fiscal framework

The Scottish Government argues that, despite being in deficit, Scotland has been in a stronger position in relation to public finances, relative to the UK. Scotland's fiscal position is impacted by the volatility of oil revenues and will also be subject to longer-term pressures such as demographic change. An independent Scotland would also be expected to take on a share of UK net debt. In this context, a number of studies look at the commitments that have been made by the Scottish Government, such as that to 'triple lock' pensions and to invest oil wealth for future generations, and attempt to estimate the impact of these on Scottish public finances.

Table 3 – Key research in the area of public spending and the fiscal framework

Title	Published by	Overview
First Report – Macroeconomic Framework	Fiscal Commission Working Group (February 2013)	This report puts forward recommendations with regard to the macroeconomic framework of an independent Scotland. In principle the Group sees merit in investing a proportion of the receipts from North Sea revenues into an oil fund to invest for future generations. As Scotland is currently running a budget deficit, in the near term it would have to use North Sea revenues to fund public services and reduce borrowing, but this does not negate the concept of an oil fund.
Scotland's Economy: the case for independence	Scottish Government (May 2013)	Annex A considers Scotland's balance sheet over the period 2007-08 to 2011-12 and finds that Scotland's estimated fiscal deficit was smaller than the UK's over the period.
Maximising the Return from Oil and Gas in an Independent Scotland	Scottish Government (July 2013)	This report states that, with more than half of oil and gas reserves by value still to be extracted, there is ample opportunity to invest Scotland's oil wealth for future generations. Findings suggest that the industry could generate £41bn-£57bn revenues over the six years to 2017-18. The Scottish Government also proposes three overarching principles to underpin the oil and gas fiscal regime: 1. The fiscal regime must support and incentivise production. 2. There should be long-term stability and certainty as well as formal consultation prior to reforms. 3. There should be fiscal incentives to maximise recovery rates.
Government spending on benefits and state pensions in Scotland: current patterns and future issues	David Phillips, Institute for Fiscal Studies (July 2013)	This paper looks at current and future welfare spending in Scotland. It finds that benefit spending per person in Scotland in 2011–12 was 2% higher than the average for Great Britain. However, the gap has been shrinking in recent years, reflecting, at least in part, the fact that the proportion of Scots claiming that they have a health problem that limits their daily activity, or a disability that restricts their ability to work, is generally higher. If Scotland becomes independent, or if benefits policy is devolved to Scotland within the United Kingdom, there would be an opportunity to reconsider a number of recent poorly-designed reforms and undertake more radical reform. However, major reforms would likely either

		create large numbers of losers, many of whom are likely to have low incomes, or else involve a substantial increase in overall benefit spending. The report highlights that the Scottish Government's 'triple lock' pensions commitment would become costly in the long term. Higher spending on health and social care also suggests that demographic change will place a greater burden on Scotland's public finances than it will on Great Britain as a whole.
Pensions in an independent Scotland	Scottish Government (September 2013)	This paper highlights a number of Scottish Government commitments with regard to state pensions in an independent Scotland, including that; everyone currently in receipt of the Basic State Pension, Graduated Retirement Benefit, State Earnings Related Pension Scheme or the State Second Pension would continue to receive these pensions as now, on time and in full, the Basic State Pension will be increased in line with the Triple Lock from 2016 for the first term of an independent Scotland (this means that pensions increase by average earnings, CPI inflation, or 2.5 per cent – whichever of these is highest) and an Independent Commission on the State Pension Age would be established and tasked with considering the appropriate rate of increase of the State Pension Age for Scotland over the long term, bearing in mind factors such as life expectancy and fairness.
Government spending on public services in Scotland: current patterns and future issues	Ben Deaner and David Phillips, Institute for Fiscal Studies (September 2013)	Under current constitutional arrangements, the Scottish government determines how much is spent on most public services, with the major exceptions being defence and international affairs. How much an independent Scotland would choose to spend on these areas would be the choice of its government. The Scottish Government says that it would aim to spend about £2.5 billion per year on defence – around £900 million less than is spent on behalf of Scotland by the UK government in 2011–12 – and would want to aim to spend up to 1% of gross national income on overseas aid – about £400 million more than if Scotland kept to the 0.7% target the UK has signed up to. Such plans would leave Scotland spending a greater fraction of national income than most small advanced economies on defence, and make it one of the largest aid donors relative to national income in the world. An independent Scotland might want to maintain a stronger fiscal position than the UK, both in order to gain credibility in the financial markets and as preparation for the longer-term fiscal challenges of an ageing population and the eventual inevitable decline of North Sea revenues.
Scotland analysis: Macroeconomic	UK Government (September 2013)	This paper describes some of the fiscal consequences of independence. For example, it states that an independent Scotland would be directly

and fiscal performance		exposed to a narrower tax revenue base and more volatile fiscal position. It also highlights that, based on forecasts of Scotland's fiscal position in 2016-17 by the Centre for Public Policy for Regions, for an independent Scotland to start an oil fund in 2016-17 from a balanced budget, additional fiscal consolidation of 5.1 per cent of GDP, or £8.4 billion in real terms, would be needed. That implies nominal spending cuts of 13 per cent from current levels, or onshore tax rises of 18 per cent. The paper goes on to state that as part of the UK, Scotland achieves many of the benefits of an oil fund: the UK's integrated fiscal model provides a very stable level of Scottish expenditure, without the need for Scotland to run the onshore fiscal position required for an oil fund.
Stabilisation and Savings Funds For Scotland	Fiscal Commission Working Group (October 2013)	The Group's recommendations include that: • The Scottish Government should establish a short-term stabilisation fund to manage year on year changes in oil and gas tax revenue immediately following independence. • The Scottish Government should plan its public finances and borrowing requirement on the basis of a cautious forecast for oil and gas revenue. • The Scottish Government should establish a long-term savings fund immediately following independence. This will ensure that a proportion of the wealth generated from the taxation of Scottish oil and gas production can be invested in financial assets and thereby provide a permanent revenue stream for future generations.
Fiscal sustainability of an independent Scotland	Michael Amior, Rowena Crawford and Gemma Tetlow, Institute for Fiscal Studies (November 2013)	This report examines the long-run fiscal pressures that an independent Scotland would face including demographic change and borrowing and debt, and the size of the fiscal consolidation that would be required to put public finances on a sustainable path. It concludes that a significant further fiscal tightening would be required in Scotland, on top of that already announced by the UK Government. It's basic model estimates that, without policy action, Scotland would require a permanent tax increase or spending cut equal to 4.1% of Scottish national income to be implemented in 2021-22, to put Scottish public sector debt on course to reach 40% of national income by 2062-63.
Fiscal Rules and Fiscal Commissions	Fiscal Commission Working Group (November 2013)	The Group recommends that an independent Scottish Fiscal Commission should form a key part of the fiscal framework of an independent Scotland. It also suggests that, within a monetary union, fiscal rules should be clearly defined while allowing each member to take a flexible approach to decisions over the level and composition of their tax systems and public spending.
Can an Ageing	Katerina Lisenkova	The aim of this paper is to isolate the effects of

Scotland Afford Independence?	and Marcel Mérette, National Institute of Economic and Social Research (December 2013)	population ageing in the context of potential Scottish independence. Modelling is undertaken to evaluate the two scenarios. The status quo scenario assumes that Scotland stays part of the UK and all government expenditures associated with ageing population are funded on a UK-wide basis. In the independence scenario, Scotland and the rest of the UK pay for the growing demands of the ageing population independently. The results suggest that Scotland is worse off in the case of independence because the effective labour income tax rate in the independence scenario has to increase further compared with the status quo scenario. The additional increase reaches its maximum in 2035 at 1.4 percentage points. The additional rise in the tax rate is non negligible, but is much smaller than the population ageing effect (status quo scenario) which generates an increase of about 8.5 percentage points by 2060. The difference for government finances between the status quo and independence scenarios is thus relatively small.

Borrowing and debt

In the event of independence the UK Government has committed to in all circumstances honour the debt issued by the UK Government (2014). The Scottish Government has stated that it is prepared to negotiate taking on a proportionate share of the UK national debt as long as it receives a proportionate share of assets. A number of publications have looked at the different ways that the share of debt that Scotland would take on under independence could be both calculated and serviced. Commentators have stated that taking on a share of the UK debt will be important for Scotland in building up credibility in the financial markets. A NIESR publication considers the factors influencing the costs of borrowing that an independent Scotland could face.

Table 4 – Key research in the area of borrowing and debt

Title	Published by	Overview
First Report – Macroeconomic Framework	Fiscal Commission Working Group (February 2013)	This report states that there are no agreed international rules on the division of assets in liabilities in the context of state succession or independence, and there is a lack of clear precedent or consensus. The Group highlights three hypothetical options for managing and servicing Scotland's national debt: 1. Transferring a proportion of UK gilts to the Scottish Government immediately post-independence. 2. Paying an agreed share of debt interest on outstanding debt until maturity then repays the principal, with any new debt issued separately by the Scottish Government. 3. As above, but with the issue of sterling bonds jointly by both Governments. The group also recognises that if Scotland assumes a per capita share of debt, the debt to GDP ratio

		would remain high by international and historic standards and a key objective for the Scottish Government will be managing this debt down.
Scotland's Economy: the case for independence	Scottish Government (May 2013)	Annex A considers Scotland's notional public sector net debt and estimates that between 1980-81 and 2011-12 Scotland run a cumulative net fiscal deficit equating to 5.1% of the UK's. Applying this ratio to the UK figure for net debt in 2011-12 gives Scotland a notional share amounting to £56 billion. A per capita share would amount to £92 billion.
Scotland's Currency Options	Angus Armstrong and Monique Ebell, the National Institute for Economic and Social Research (September 2013)	If Scotland continues using sterling, NIESR estimate that it would face additional interest rate costs of between 0.72% to 1.65% above the UK borrowing costs for 10 year debt. They also estimated that Scotland would have to run a tight fiscal policy to achieve a sound debt level under those borrowing costs. Such a fiscal tightening would leave an independent Scotland with very little room for fiscal manoeuvre in the case of a negative shock, such as a drop in the oil price or a recession. The team propose a novel way of reducing the initial debt burden – an oil for debt swap.

ECONOMIC FOCUS

A number of reports consider the economic levers that an independent Scotland might use to achieve objectives such as economic stability and growth. Others consider the impact that independence might have on businesses, in particular in relation to trade and bureaucracy. The Scottish Government and UK Government also consider the regulatory framework that would be desired/necessary in an independent Scotland.

Table 5 – Key research in the area of economic policy and regulation

Title	Published by	Overview
First Report – Macroeconomic Framework	Fiscal Commission Working Group (February 2013)	This report highlights the range of new policy levers that the Scottish Government would have under independence to boost growth, address inequality and stabilise the economy. This includes taxation levers such as corporation tax, oil and gas taxation, excise duty and VAT. It also includes non-tax based levers such as financial regulation, consumer protection and industry regulation.
Scotland's Economy: the case for independence	Scottish Government (May 2013)	This paper highlights the policy levers which an independent Scotland could use to tackle income inequality, create rewarding employment, counterbalance the gravitational pull towards London and stimulate growth in key sectors. Suggested developments for an independent Scotland include simplifying the economic regulatory landscape so that there is just one regulatory body.
Scotland analysis: Financial services and banking	UK Government (May 2013)	This paper considers the implications for the financial sector and the wider public if Scotland were to become independent. It highlights a number of key issues. For example, it states that an independent Scotland's financial sector would be exceptionally

		large compared to the size of its economy (around 1,254% of GDP), making it more vulnerable to financial shocks than it is as part of the larger UK. In addition, it states that there could be questions about an independent Scotland's ability to stabilise its banking system in the event of a future financial crisis. It goes on to explain that these factors would be likely to increase the risks of financial services firms operating in an independent Scotland and large firms may look to restructure, e.g., so that they were no longer headquartered in Scotland. It also states that the single regulatory framework could not continue in an independent Scotland and that, if an independent Scottish state became a member of the EU, it would be required to establish its own financial regulator.
Scotland analysis: business and microeconomic framework	UK Government (July 2013)	This paper looks at the implications of an independent Scotland for business and the microeconomic framework. For example, it suggests that, in the event of independence, the introduction of an international border would almost certainly have a negative impact on trade. It also states that small companies with little cross-border experience are likely to be hampered most by the creation of barriers to trade and added bureaucracy. It also highlights that there would be substantial direct cost arising from creating a new institutional framework for independent Scottish state and extra annual operational costs. Different regulatory and tax systems are likely to diverge over time, increasing the barriers to trade on both sides of the border and increasing the cost of compliance for firms who have to comply with two different systems. It concludes that the size and scale of the UK market brings opportunities to trade, move jobs, collaborate to develop new and future technologies, travel and communicate with each other efficiently and benefit from economies of scale.
Consumer Protection and Representation in an Independent Scotland: Options	Scottish Government (August 2013)	This paper proposes that an independent Scotland could create a single consumer body to protect, educate and advise consumers and a 'one stop shop' Consumer Ombudsman (with the potential exclusion of financial services) that would operate independently of the consumer body and address complaints quickly and effectively.
Scotland analysis: Macroeconomic and fiscal performance	UK Government (September 2013)	This paper describes some of the potential economic consequences of independence. For example, it states that policy divergence between an independent Scotland and the continuing UK would be likely to lead to a weakening of economic integration and the loss of some business networks. These changes would be expected to trigger a "border effect" reducing flows of trade, labour and capital between Scotland and the continuing UK. If

		the relationship between Scotland the rest of the UK were to become similar to that between euro area countries, the border is likely to reduce the level of real income in the Scottish economy by around 4 per cent after 30 years, with the effect building over time. An independent Scotland could look to new markets to offset this drag on growth but it is not clear whether this would be able to compensate for the effect on trade lows with the continuing UK.
Scottish and UK economy – Key facts	Scottish Government (November 2013)	States that current economic policies are for the whole of the UK – often heavily determined by the interests of London and the South East of England – not tailored to Scotland's needs. Suggests that policies under independence could include: • Boosting competitiveness through the design of a more efficient tax system and the use of carefully targeted tax measures, such as a reduction in corporation tax and the effective use of tax reliefs and allowances to support Scottish businesses • Promoting innovation by establishing a framework – including a balance of direct and indirect innovation support – which supports activity across the private and public sectors • Creating a genuine partnership approach to developing, and taking forward, economic policy – involving the public, private and third sectors alongside employers and employees.

WELFARE AND EQUALITY

The Scottish Government state that independence will allow them to have more effective levers to tackle income inequality. Research by the University of Stirling looks at which policy levers are most effective at tackling inequality (such as control over aspects of welfare and the ability to vary income tax rates differentially) and also looks at the factors which might limit the extent to which an independent Scotland could mitigate inequality (such as global trends).

Table 6 – Key research in the area of welfare and equality

Title	Published by	Overview
Scotland's Economy: the case for independence	Scottish Government (May 2013)	Highlights the policy levers which an independent Scotland could use to tackle income inequality, create rewarding employment, counterbalance the gravitational pull towards London and stimulate growth in key sectors. Suggested developments for an independent Scotland include: • Exploring mechanisms to formalise the relationship between Government, employer associations and employee associations. • Using fiscal incentives to provide employer investment in training and development.
Inequality in Scotland: trends, drivers, and implications for the	David Bell and David Eiser, University of Stirling (November 2013)	Finds that inequality is much higher in Scotland than in the Nordic countries, but slightly less than in rUK. Although there has been relatively little increase in inequality in Scotland since the mid-1990s, inequality at the extreme ends of the distribution has increased

independence debate		in the last decade. Much of the increase in inequality has been driven by increased variability in working time. An independent Scotland would gain access to a wider range of fiscal levers with which it could tackle inequality, notably around taxation and welfare spending. However, there are limits to the extent to which a small open economy can mitigate inequality given that many drivers are linked to global trends in technology, trade and family formation practices.
Constitutional change and inequality in Scotland	David Comerford and David Eiser, University of Stirling (January 2014)	This paper looks at the scope that a sub-national economy has to affect the level of inequality and what powers are required to affect inequality measures. The authors estimate that to achieve an equivalent level of net income inequality as in countries such as Denmark or Norway requires a fall in Scotland's GINI of around 5 percentage points. The fiscal policy levers which the Scottish Government already (or will soon) have access to are relatively blunt tools with which to address inequality. Further devolution of income tax (at least to include the ability to vary rates differentially, but potentially also to vary thresholds as well), as proposed by the proponents of Devo-More and DevoPlus, would provide the Scottish Government an opportunity to more effectively use fiscal policy to influence income distribution. But full control over low income and out of work welfare benefits would provide other important levers with which to influence inequality. However, the results presented show that it is difficult for a small open economy to implement substantially different redistributive policy from that of its close partners. Therefore, even with full autonomy for tax and benefit policy, the Scottish Government might need to look beyond fiscal policy and redistribution to achieve the substantial reductions in inequality that it desires.

Note that this is not an exhaustive list of research in these areas. Additional research can be accessed at The Scottish Parliament's Referendum Hub webpage.

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