

## The Scope for Economic Policy after Independence<sup>1</sup>

By Gavin McCrone

The Scottish Government has said that, if the electorate choose independence in the forthcoming referendum, it would give them the levers to improve Scotland's economic performance and the welfare of the people. The purpose of this paper is to consider the additional powers that would be available and the scope for using them.

Economic arguments have formed a large part of the case for independence, as set out by the SNP, ever since the growth in support for their party in the late 1960s. This is unusual. Most commonly when countries split to form independent states it is because of differences in culture or serious grievances about the way they have been treated. Whatever the economic consequences, they take the view that they simply do not want any longer to be part of the larger state with which they have been associated. There have been numerous examples: the breakup of the Soviet Union, the collapse of Yugoslavia and even the independence of what then became the Irish Free State and is now the Irish Republic. In this latter case, although the economic condition of Ireland within the UK during much of the previous century certainly gave grounds for serious grievance, even there, as with the other countries, little if any detailed argument about the economic consequences of independence or the policies that a separate state might pursue took place.

Scotland has its own distinct culture and history. Moreover, during my lifetime I have witnessed the development of a growing awareness of Scotland's separate identity and the confidence that goes with that. Nevertheless, it is not so difficult to understand why the argument about the economy features as much as it does in the Scottish context. Scotland had its industrial revolution early and during those years the economy grew rapidly. But this early success left a legacy of problems which were to dominate the economy for much of the 20<sup>th</sup> century, as it did also in the north of England and South Wales, when the traditional industries of coal, steel, textiles and shipbuilding together with associated engineering went into decline. While in the post-war decades unemployment remained low by present day or pre-war standards, it was frequently twice the rate for the UK, and net emigration was extremely high, amounting over the decades of the 1950s and 1960s to a total of 609,000, approximately half of which was to the rest of the UK and half overseas. This was equivalent some 30 per cent more than the whole population of Edinburgh<sup>2</sup>. There were serious problems of deprivation in some of the industrial areas, notably in the west of Scotland, a problem that persists to this day. Scotland was, of course, not the only part of the UK suffering these problems. But they gave rise to a feeling in Scotland that the country's economy was somehow not doing as well as it should and that government in London was not doing enough.

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<sup>1</sup> A shorter version of this paper, but containing many of the arguments, was published in *The Scotsman* on the 12<sup>th</sup> July 2012.

<sup>2</sup> *Scottish Abstract of Statistics*, No 5, 1975.

The UK Government, through its regional development policy, especially through the 1960s and 1970s, attempted to deal with this problem. Considerable success was achieved through the introduction of new industries, most notably electronics. But it did not eliminate the problem. What was achieved was not always recognised and the details of successive regional development policies were largely lost on the general public. The sense of grievance to which this gave rise has therefore been a major factor in the growth of support for independence. If, as part of the UK, Scotland's economic performance falls below hopes and aspirations, it is not surprising if people begin to wonder if it might do better on its own.

This feeling received a major boost when North Sea oil and gas were discovered in the 1970s. The vast bulk of the oil discoveries (though not the gas) were off the Scottish coast and under international rules would have been in Scotland's offshore territory, were it an independent state. The importance of this seemed at first to be underestimated by the UK Government and it was some time before appropriate policies to give benefit to the state were put in place, but once this was done the revenues from taxation were very large indeed and of major benefit to the UK exchequer. No longer did it seem so persuasive to the general public to argue that Scots would be worse off if their country became independent. It was no surprise therefore that support for independence grew.

Ironically Scotland's relative economic position within the UK is enormously better now than it was in the early 1970s. Scotland's gross value added (GVA) per head at 98.7 per cent of the UK average in 2010 is exceeded only by London and the South East of England (Table 1). At a lower level of aggregation (NUTS 2) the north east of Scotland is now one of the most prosperous parts of the UK with a GVA per head of 144 per cent of the UK average, second only to Inner London. This compares with the situation in the late 1950s and 1960s when Scotland's GDP per head was consistently less than 90 per cent of the UK average and in some years some 12 per cent below, making it one of the poorest parts of the UK<sup>3</sup>. In contrast the Northern Region of England and Wales seem to have fallen somewhat further behind the UK average over the same period. Net migration is now into, rather than out of, Scotland and unemployment until the latest count was fractionally below the UK average. It is now only slightly above. This turnaround is partly a consequence of the 1960s and 1970s regional policies, including the setting up of the development agencies (now Scottish Enterprise and Highlands and Islands Enterprise) but also the remarkable growth in Scotland of the financial services sector and employment across a range of industries associated with the development of North Sea oil and gas. In addition the decline of the older industries has now reduced them to a size where they are no longer a drag on the performance of the economy.

Nevertheless the argument for independence on economic grounds is still made. Scotland's growth is compared unfavourably with other countries of similar size, many of which have quite different economic circumstances. It is also compared unfavourably with the UK where aggregate GVA has grown faster than in Scotland over a long period; but this ignores the

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<sup>3</sup> *Scottish Abstract of Statistics* (various years). For estimates of GDP per head in 1960 and throughout the 1950s see my *Scotland's Economic Progress 1951-1960*, p. 32-36, George Allen and Unwin, London, 1965.

fact that it is not the growth of GVA in aggregate but GVA per head that is a guide to the wellbeing of the population. Inward migration has been much higher in the south of England than in Scotland and it is therefore not surprising that aggregate GVA has risen faster for the UK as a whole than for Scotland: but at the same time the gap in GVA per head has narrowed so that in Scotland it is almost equal to the UK average.

### **The Case for Additional Powers**

The above analysis must not, however, give grounds for complacency. We would all like to see the Scottish economy performing better – poverty and deprivation being eliminated, a stronger growth of new industry, especially indigenous industry, to replace the industries that have declined and to provide high quality employment for the future. But it is against this background that the economic arguments for independence and the case for additional powers should be judged.

#### *Taxation*

The recently enacted Scotland Act confers substantial additional powers and many people probably do not yet realise the extent to which the Scottish Government's responsibilities have been increased. The Act will make the Scottish Government responsible for raising approximately half of income tax, for all of stamp duty land tax and landfill tax. It is also to be free to introduce new taxes should it wish to do so. It would be possible to go further. It is rumoured that the Treasury would be prepared to consider handing over the responsibility for all of income tax, if it is decided to increase further the devolved powers of the Scottish Parliament. The main argument against this, as the Calman report pointed out, is that it would leave Scotland heavily dependent on one tax<sup>4</sup>. It would also be possible to assign the proceeds of VAT in Scotland, although under EU rules the *rate* could not be altered so long as Scotland remained part of the UK. VAT is levied at different rates by individual EU countries, although within certain limits, but different rates *within* a country are not allowed under the rules. These taxes together with business rates and council tax, which are already the responsibility of the Scottish Government, would cover some 66 per cent of the expenditure for which the Scottish Parliament is presently responsible.

What the Scottish Government have indicated they would like to do is to follow the Irish example of very low corporation tax to encourage industrial investment. If Scotland remains within the UK, it would be theoretically possible for there to be some difference in corporation tax rates. Under EU rules, following the Azores case, where the Portuguese Government argued for different tax rates of corporation tax because of the special circumstances of the islands, it was established by the European Court of Justice that different rates were permissible, so long as the cost was met by the territory concerned and was not a subsidy from the rest of the country<sup>5</sup>. In Scotland's case therefore any reduction in

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<sup>4</sup> *Serving Scotland Better: Scotland and the United Kingdom in the 21<sup>st</sup> Century*; final report of the Commission on Scottish Devolution, Edinburgh, June 2009.

<sup>5</sup> European Court of Justice, Case C-88/03 (2006) – *Judgement of the Court – Portugese Republic V. Commission of the European Communities*.

revenue from a lower corporation tax would have to be met from other taxes raised in Scotland and not from an increase in the block grant.

The Holtham Commission on Wales actually proposed some variation in corporation tax, but this was related to the level of GVA per head as compared with the UK average<sup>6</sup>. Parts of the UK with GVA per head of between 70 and 80 per cent of the UK average, the Commission suggests might be allowed to discount corporation tax by 25 per cent and those with even lower GVA per head by 35 per cent. The block grant would then be cut by the amount of revenue lost to conform to the Azores judgement. But on the basis set out by Holtham, Scotland would not qualify, since its GVA per head is so close to the UK average. It is also hard to see the rest of the UK accepting a cut in Scotland's corporation tax while still remaining in the UK, as it would be seen as an attempt to distort competition to the disadvantage of other parts of the country. It might provoke some form of retaliation and would probably result in pressure, especially from parts of the UK where GVA per head is well below the level in Scotland, such as the Northern Region of England or Wales, to reduce Scotland's block grant by even more than the amount required to satisfy the Azores rule. Such pressure already exists, as the Barnett formula arrangements are widely seen as enabling Scotland to retain a more generous share of public expenditure than conditions in Scotland justify<sup>7</sup>.

With independence Scotland would, of course, have to raise all of its own tax revenue, including personal taxation, VAT and corporation tax, just as it would be responsible for all of its public expenditure. But there would still be constraints. If personal taxation was different from the rest of the UK, there would be a risk that people would vote with their feet, though I suspect that the difference would have to be significant, certainly larger than differences in council tax, for this to become an issue. Differences in VAT or in excise duties, while allowed under the rules, could encourage trading across the border, as happens now with alcohol between Britain and continental countries. If the Scottish Government tried to reduce the rate of corporation tax well below that of other countries, with the aim of attracting economic activity that might otherwise go to other member states, that would raise problems both with the European Union and with the remainder of the UK. As it is, several EU countries have taken issue with Ireland's low 12.5 per cent rate of corporation tax, notably at the time of the Irish financial bail-out, arguing that it was unacceptably distorting. While Ireland has so far managed to resist this pressure, it is unlikely that a newly independent Scotland seeking to establish itself within the EU would be able to do so.

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<sup>6</sup> *Fairness and Accountability: A New Funding Settlement for Wales*, final report of the Independent Commission on Funding & Finance for Wales, Cardiff, July 2010

<sup>7</sup> The Barnett formula is no more than a population ratio determined share of additions (or reductions) to public expenditure. As such it was expected by many including the present author to lead to a gradual convergence in Scotland's public expenditure per head with the UK average. This has not happened, at least not to the extent expected for which there are many reasons. The resulting distribution is not needs related and the Holtham Commission argues that a needs based formula would give Wales more and Scotland significantly less than it presently receives through the block grant.

### *Monetary Policy*

The Scottish Government have said that it would be their intention to keep sterling as the national currency following independence and that the monetary union of the UK would continue. But this leaves a host of important questions unanswered. Would the Scottish Government sell its own bonds on the market and, if so, what interest rate might they have to pay? How much influence would the Scottish Government have on the Bank of England's monetary policy? On what conditions would the Bank of England be prepared to continue as lender of last resort for Scotland? It would seem that no discussions about this with the Bank have so far taken place. If the Scottish Government wanted it to perform this role, the Bank's agreement and that of the Government of the remainder of the UK would have to be sought. This may not be easy and could well meet with refusal if the remainder of the UK was not satisfied with the economic policies being followed by the Scottish Government.

Even if agreement was reached to enable the Bank of England to act as a central bank for both countries, it might be possible, following the example of the European Central Bank (ECB), to argue for a Scottish member of the Court of the Bank or whatever governing council or board it might have. Scottish Ministers have said they would wish Scottish representation on the Bank's Monetary Policy Committee (MPC). But, again, that might be refused. None of the present members of the MPC or the Court is there to represent a particular territory. And, as the example of European monetary union shows, representation on the board of the ECB does not guarantee a monetary policy that suits all members; inevitably the largest economies are those to which the bank pays most regard in deciding its policy.

Alternatively, within the monetary union might there be a Scottish central bank; would it then be able to act as lender of last resort? This might depend on whether Scotland continued to use Bank of England notes or re-established the separate pound Scots, which could be pegged to be exchangeable at par with sterling. If the European example is a guide, within EMU the individual central banks of member states do not have money creation powers and therefore cannot act as lenders of last resort for their respective countries. Had they retained their own currencies, but linked them to the euro, they might have been able to do so but, depending on the circumstances, their actions could then put the currency link under great pressure, eventually forcing it to break to form a new exchange rate. This is what happened with the European Exchange Rate Mechanism (ERM), which preceded the single currency.

Here the experience of Ireland is interesting, although, of course, the present circumstances of Scotland and those of the then Irish Free State in 1922 are very different. When it became independent, Ireland retained sterling as its currency and conditions were much as they are in Scotland now: Bank of England notes continued to circulate and the Irish banks issued notes of their own, which were accepted as sterling both by businesses and members of the public and were backed by deposits at the Bank of England. The first Irish Banking Commission set up in 1926 proposed introducing Ireland's own currency notes but emphasised the importance of retaining the 1:1 parity with sterling. These notes were therefore exchangeable at par with Bank of England notes and managed by an Irish Currency Commission. In 1934 there was a second Banking Commission, one of the main recommendations of which was the

establishment of a central bank. But Ireland did not actually get a central bank until 1943, following the Central Bank Act of 1942. The remarkable consequence of all this was that in the absence of any formal agreement with the Bank of England, Ireland was without a lender of last resort for some 21 years. This is particularly surprising, considering that these years included the depression and the first four years of a world war.

Mercifully this need did not arise, as no Irish banks got into trouble during this time and successive governments operated extremely conservative fiscal policies. With much greater speculative activity now a feature of financial markets, it is hard to see an independent Scotland getting away with having no lender of last resort. Nor, one imagines, would an independent Scotland trying to stimulate its economy and wanting to use fiscal levers for this purpose be content with an extremely conservative fiscal policy of the kind followed by Ireland after independence. With a deficit of 7.4 per cent of GDP in 2010-11, however, (even including a geographical share of North Sea revenues) there would hardly be scope for an expansionary fiscal policy.

Was Ireland right to follow this policy of retaining the link with sterling through thick and thin? Successive experts, including the First Banking Commission and the majority report of the Second argued strongly for this. But the minority report of the Second Commission strongly disagreed saying that they could not:

‘...acquiesce in the extraordinary view that this country, alone among responsible entities in the world, should not ever have the power to make decisions, and no apparatus or mechanism for controlling the volume and direction of credit should ever be brought into existence.’<sup>8</sup>

Nowadays there are those in Ireland who strongly criticise the policies pursued in the early decades after its independence. Conor McCabe, for example, argues forcefully that given the poor and underdeveloped state of the Irish economy at that time, retaining an overvalued currency, which is what the parity link with sterling implied, was profoundly damaging to the economy and was one of the factors which led to Ireland’s relative stagnation during that time.<sup>9</sup>

What is clear is that if an independent Scotland wished to continue to use sterling, there would have to be negotiations with the rest of the UK and the outcome of these negotiations would be crucial to how policy operated. If the Scottish Government wanted to borrow using common sterling bonds, like the eurobonds proposed but not yet implemented for the EU, that would imply that they were guaranteed by both the UK and Scottish Governments. For this to be acceptable, the rest of the UK and Scotland would have to be satisfied on the sustainability of each other’s fiscal policy, just as eurozone countries now see the need for fiscal union to support its monetary union. If on the other hand Scotland decided to issue its own bonds to cover any necessary borrowing, these might require a higher interest rate than

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<sup>8</sup> The Irish Times, 9 August 1938.

<sup>9</sup> Conor McCabe, *Sins of the Father: Tracing the Decisions that Shaped the Irish Economy*, The History of Press Ireland, Dublin, 2011

for the rest of the UK until the market was satisfied, as a result of experience, that they were equally safe and fully backed by a lender of last resort.

So there is much that would need to be decided and many issues that have not as yet even been discussed. If Scotland does decide to become independent, my own view is that it would probably be best to have a separate central bank and, if it was to be given power to act as lender of last resort, a separate currency as well. This could be pegged to sterling or indeed the euro, depending on circumstances. Many smaller countries in Europe, where they still have their own currencies, have found that it makes sense to shadow the currency of a larger area, usually the euro. But this still gives them freedom, in extremis, to allow their currencies to be revalued either up or down, should the need arise; the kind of problems that are now so distressingly evident among the southern countries in the eurozone could then be avoided, or at least substantially mitigated.

#### *The Importance of North Sea Oil Revenues*

A separate Scottish currency would be greatly influenced by the price and volume of North Sea oil produced. The inclusion of the North Sea on a geographical basis makes a substantial difference on paper to the size of the Scottish economy. It would immediately add about 22 per cent to Scotland's GVA, though without much effect on the welfare of the population<sup>10</sup>. It would, of course, provide a large flow of taxation revenue. But because of Scotland's present budgetary position (Table 2), this revenue from the North Sea would be essential to balance the Government's budget, unless either other taxes were to be raised or expenditure cut on top of the cuts already taking place. North Sea revenue would obviously be a much larger component of a Scottish Government's budget than it has been of the budget of the UK, very significant though it has been there too. Its contribution to the balance of payments would also be a very important.

The problem is that revenue from oil and gas has fluctuated greatly over the years. It was high in the early 1980s, reaching a peak of £12.3 billion in 1984-85 (if expressed in present day prices, this would have amounted to almost £30 billion) of which Scotland on a geographical basis might have had approximately a 90 per cent share. But it fell to only about £1 billion in the early 1990s before rising again to £12.9 billion in 2008-09 (Table 3). Despite this, North Sea oil revenues in *real* terms have never got back to the level of the early 1980s and are unlikely to do so in the future. Output of oil reached a second peak in 1999 and is now gradually declining. And although production can be expected to continue for many years yet, even with significant new discoveries this decline is unlikely to be arrested. Price has fluctuated more than production, falling in the second half of the 1980s and rising again after 2000. Volatility of price is therefore the main cause of the volatility in tax revenue. Many people expect the oil price to go on rising and maybe it will, thereby keeping the oil revenues up. But the discovery that very large supplies of gas can be obtained through 'fracking' not only in the United States, where they are forecast to make the country self-sufficient, but also in Northern Europe, makes any forecast of government revenue from oil

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<sup>10</sup>Government Expenditure & Revenue Scotland 2010-2011, Scottish Government, Edinburgh, March 2012

and gas extremely uncertain. This suggests that if a Scottish Government was depending on revenue from oil taxation to balance its budget, it could face a dangerously volatile situation.

The implications of North Sea oil revenues for the balance of payments and the exchange rate are also considerable and could be the opposite of those for the Government's budget. The higher the revenues the more it brings in to the Scottish Government's budget. But a high oil price and high revenues carry the danger that by generating a large balance of payments surplus they could push the exchange rate up, thereby threatening damage to the non-oil economy. This is not a minor concern. The Dutch economy suffered in the 1970s when discoveries of natural gas threatened to damage non-gas related activities and this became known as 'the Dutch disease'. In the same way the massive growth in UK oil revenues in the early 1980s was one of the factors that brought about a very sharp rise in the sterling exchange rate, which in turn was a major factor in the recession of those years<sup>11</sup>. The Scottish Government would therefore have to stand ready to counteract this effect by investment abroad, or by any other means, if the rest of the economy was in danger of being affected.

The Norwegian Government has very wisely been paying a substantial part of its revenue from oil and gas into a special reserve fund since the 1990s, with the result that the country now has one of the largest wealth funds in the world, amounting to some £328 billion<sup>12</sup>. Even the annual income from this investment is now very large. This also means that it is not so dependent on oil revenues to balance its current budget as Scotland would be. It is one of the UK's great missed opportunities that Governments here did not do the same, when they could have done, especially in the 1980s. Alex Salmond has argued that Scotland should follow the Norwegian example and pay its North Sea revenues into a special fund. But that money would be needed to balance the Government's current budget, however desirable it may to do otherwise, unless and until the budget is balanced either by extreme fiscal tightening on top of the existing difficult fiscal situation, or somehow through greatly improved economic growth. All of this would affect the view taken by the markets both of the Scottish currency and bonds.

So there is much that needs to be decided and discussed before the referendum in 2014. As part of the UK, Scotland has been a member of a state where revenue and expenditure in the individual territories and regions did not need to balance. Indeed only in Scotland with the publication of *Government Expenditure & Revenue Scotland* was it possible to see these components set out and the balance between them<sup>13</sup>. Estimates for other parts of the UK have periodically be made by researchers but there is no regular official publication of them. Generally the policy has been that the stronger parts of the country help the weaker, thereby enabling a comparable standard of public services to be maintained, which they would otherwise be unable to afford. There have also been regional development policies to help growth in areas in need of development or to replace activities that have declined.

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<sup>11</sup> This effect was of course compounded by the very tight monetary policy adopted by the UK Government in the early 1980s.

<sup>12</sup> This is generally known as the 'oil fund'. Originally it was the Petroleum Fund of Norway but since 2006 has been renamed the state pension fund (Statens pensjonsfond-Utland).

<sup>13</sup> *Government Expenditure & Revenue Scotland* has been published annually since 1992 and gives estimates back as far as 1986-87. The estimates have been steadily improved in quality since their initial publication.



Such policies have varied in strength depending on the philosophy of the government of the time. But Scotland has, over the last half century at least, been one of the parts of the UK benefitting from such policies. Within federal states similar transfer mechanisms and development policies usually exist. The Scottish electorate would therefore have to decide whether it wanted to retain the safety net of being part of a larger country, where there is a generally comparable standard of public services, regardless of what can be afforded from local taxation at any particular time; or whether for the sake of being independent, it will take the risk that there may be times when, perhaps because of a drop in oil revenues or some other reason, taxation revenue falls and public expenditure has to be cut to match it. Those who argue for independence or some form of complete fiscal autonomy for Scotland such as devo-max need to face this, as their policies would end such inter-regional transfers.

While I have no doubt that as an independent country Scotland could be perfectly viable economically, there could be a bumpy ride for a number of years, depending on what is decided for the currency, how taxes and public expenditure are to be structured and how revenue from the North Sea is to be handled. The truth is that there is much that the Scottish Government can do with its existing powers to improve the growth of the economy and it is not so clear how the additional powers and responsibilities that would follow independence could improve it further. We need a clearer statement from the Government about the additional levers it seeks and how it would use them.

**Table 1 Gross Value Added per head as a percentage of the UK level**

<b>United Kingdom</b>	<b>100</b>
North East	76.9
North West	84.9
Yorkshire & Humber	82.6
East Midlands	88.3
West Midlands	83.3
East of England	92.8
London	171.1
South East	107.1
South West	91.2
England	102.4
<b>Scotland*</b>	<b>98.7</b>
Wales	74.0
Northern Ireland	76.4

\*If the a geographical share of output of the North Sea is added, Scotland's GVA is increased by some 20 per cent

Source: Office of National Statistics

**Table 2 Net Fiscal Balance: Scotland and UK 2006-07 to 2010-11****As a percentage of GDP**

	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
UK	-2.3	-2.4	-6.8	-11.1	-9.2
Scotland excluding North Sea Revenue	-9.9	-9.5	-13.4	-17.9	-15.6
Scotland with geographical share of North Sea Revenue	-2.4	-2.6	-2.6	-10.7	-7.4

Source: Government Expenditure &amp; Revenue Scotland 2010-2011, March 2012

**Table 3 North Sea Revenue: UK 1980-81 to 2010-11****£ billion**

<b>Year</b>	<b>£bn</b>	<b>Year</b>	<b>£bn</b>	<b>Year</b>	<b>£bn</b>	<b>Year</b>	<b>£bn</b>
1980-81	3.9	1988-89	3.3	1996-97	3.4	2004-05	5.2
1981-82	6.4	1989-90	2.5	1997-98	3.3	2005-06	9.4
1982-83	7.9	1990-91	2.3	1998-99	2.5	2006-07	8.9
1983-84	8.8	1991-92	1.0	1999-00	2.6	2007-08	7.5
1984-85	12.3	1992-93	1.3	2000-01	4.5	2008-09	12.9
1985-86	11.2	1993-94	1.3	2001-02	5.4	2009-10	6.5
1986-87	4.7	1994-95	1.7	2002-03	5.1	2010-11	8.8
1987-88	4.7	1995-96	2.3	2003-04	4.3		

Source: Government Expenditure &amp; Revenue in Scotland 2010-2011, March 2012