Introduction

In the terms of reference for the Committee’s enquiry on the economic implications of Scotland’s constitutional options, two basic scenarios are highlighted: (a) the implementation of the proposals in the Scottish government’s White Paper following a “Yes” vote in the 2014 referendum: and (b) the consequences which might follow after a “No” vote: this is understood here to mean the constitutional status quo, together with the variation in fiscal powers stemming from the implementation of the Calman proposals in the Scotland Act.

We also consider here a third possibility, which is that, whether or not Scotland votes “Yes” in 2014, Scotland opts shortly afterwards for full independence. This might involve, in particular, not being in a currency union with the rest of the UK, and hence not being bound by the (presently unknowable) fiscal rules which such a monetary union would imply. The trigger for this full independence option might be, for example, a future systemic crisis threatening the UK economy: or a vote in a future referendum in the UK against remaining in the EU.

We therefore frame our comments in this note around three possibilities:

a. A “No” vote, followed by the constitutional status quo:
   b. A “Yes” vote, followed by implementation of the White Paper:
   c. Complete independence from the rest of the UK.

The structure of this note is as follows: in the next section we look at the prospects for the economy following a “No” vote in the referendum combined with the constitutional status quo. We then consider the economic implications of independence: this is based heavily on a report we produced in 2013 on economic options under independence, (Cuthbert and Cuthbert, 2013). That report was based on a scenario of full independence: so in summarising some of the main points of that report, we also consider which of the options considered would be feasible under the type of independence envisaged in the White Paper.

Economic prospects for Scotland as part of UK

The economic prospects for Scotland, if it remains part of the UK, are gloomy, as indeed are those for the wider UK. There are several aspects to this.

Continued economic austerity

The austerity programme which has been in place since the events of 2008 is projected to tighten. On the basis of the most recent Autumn Statement by the UK Chancellor, it is projected that cuts in overall UK expenditure will be £17 billion in 2014, £20 billion in 2015, and £25 billion over 2016 and 2017. As the focus of the cuts comes increasingly to be on the non-pension element of social security, (which, it is estimated, will be cut by £12 billion over the two year period after 2015), there is
likely to be a substantial impact on Scotland because of the relatively high spend on social security in Scotland.

Present UK recovery not soundly based
What has not happened is the hoped for rebasing of the economy towards manufacturing and exports. Instead, one major contributory factor to the recent upturn in the UK economy has been the stimulation of a housing bubble, which is disproportionately affecting the South East of England. In addition, far from being the export led recovery which the Chancellor had predicted, the present upturn is heavily dependent on the consumption of goods and services, many of which are imported: as a result, the UK is currently experiencing some of its largest ever deficits on trade. The increase in consumption is, in turn, being fuelled by running down personal savings. Further, the banking system is still not lending to the SME sector, thus holding back investment and potential growth. Quantitative easing has led to asset bubbles which will prove extremely difficult, and dangerous, to unwind. The overall effect is that the present recovery is highly likely to be unsustainable, and to be followed by a repetition of previous crises.

Scottish economy likely to be affected by perverse incentives in Calman
As we pointed out in an earlier analysis of the Calman income tax proposals (Cuthbert and Cuthbert, 2011), these involve strongly perverse incentives. As we demonstrated, under all feasible scenarios a Scottish government operating under Calman would get more revenue from a 1p increase in tax rate than an independent Scottish government would from a 1p increase in its tax rate: moreover, the difference is likely to be material. That is, a government operating under Calman will always have a stronger incentive to raise income tax rates than an independent government. The result is that, if Scotland is still part of the UK, then given the climate of financial stringency under which Scottish governments will be operating within the UK for the foreseeable future, any Scottish government will probably raise income tax rates in Scotland relative to the rest of the UK. The effect is likely to be relative economic decline of the Scottish economy as compared to the UK average.

Exposure to adverse effects of UK finance based economy
Membership of the UK implies continued exposure to a variety of adverse effects of the UK financed based economy. These include the marked, and increasing, levels of inequality experienced in the UK – both inequality between different areas, and between different income groups, (see M. Cuthbert, 2013, for more detail). Another adverse effect is the risk of the UK economy experiencing another crisis like 2008: this is a very significant risk, particularly since, as noted in J. Cuthbert, (2013), the UK economy continues to operate essentially as a very large bank, with a balance sheet of external assets and liabilities which is unprecedentedly large relative to GDP, and growing.

Failure to benefit from Scotland’s natural resources
Under the union, Scotland has suffered a version of the classic “resource curse” of failing to benefit from its own natural resources. It is not just that, rather than now enjoying a sovereign wealth fund of possibly £150 billion or more, Scotland instead shares in the burden of the UK’s debt – with UK debt standing at somewhere between £800 billion and £1.2 trillion, depending on what happens to quantitative easing: (Cuthbert and Cuthbert, 2014). In addition, Scotland fails to share adequately
in the employment and profits associated both with its natural resources, and with industries like whisky. For example, Scotland has 80% of the hydrocarbon production of these islands but only 45% of the associated jobs. As regards the whisky industry, which is now largely foreign owned after a failure of effective oversight by the UK Monopolies and Mergers Commission, Scotland benefits from only about one third of the £5 billion sales connected with the industry, (Cuthbert and Cuthbert, 2013). None of this will change with continued membership of the UK.

Issues and options for the Scottish economy under independence

In August 2013, we published a paper on economic policy options for an independent Scotland, (Cuthbert and Cuthbert, 2013). In this section we will summarise some of the main points, both about the issues facing the economy of an independent Scotland, and the policy options available for addressing these issues. We will concentrate in particular on those areas where different policy options are likely to be open to a Scottish Government operating under full independence, as opposed to the White Paper version of independence.

Monetary policy

Under full independence, Scotland would have the option to establish its own currency, and so to be in charge of its own monetary policy. This would not be a painless option: the break-up of a monetary union involves significant disruption. The potential difficulty of the transition to a separate Scottish currency would, however, depend greatly on the circumstances at the relevant time, and on the way in which Scotland was achieving independence. For example, if Scottish independence came about as the result of a major systemic crisis in the UK economy, then the transitional problems surrounding the establishment of a separate Scottish currency might be relatively insignificant.

The establishment of a separate Scottish currency would, potentially, offer considerable advantages. It would enable Scotland to escape from the present UK currency union: a currency union which is clearly malfunctioning, and which is far from being an Optimal Currency Area. As evidence of this, consider

a) The way in which monetary policy and interest rate decisions are determined primarily by the needs of the City and the South East.

b) The marked inter-regional disparities in economic performance between different parts of the UK (see M Cuthbert, 2013), and the evidence of the haemorrhage of talent to London from other parts of the UK, (see, for example, the report by Centre for Cities, 2014).

c) The instability of the UK exchange rate which has led to marked, and damaging, short term fluctuations in the UK’s competitiveness, (see J Cuthbert, 2013).

The option of having a separate currency is specifically excluded under the White Paper version of independence, since the White Paper perceives a continuing currency union between Scotland and the UK.
Fiscal policy
Our options paper identified ten different ways in which the operation of fiscal policy in the UK has been detrimental to Scotland. These include, (without listing them all), a short-sighted policy on the taxation of hydrocarbon resources; a damaging refusal to countenance inter-area variations in tax rates within the UK; the UK government's refusal to use the scope it has within EU rules to employ VAT innovatively to encourage specific industries; and the adverse way in which specific taxes, like air passenger duty, have been managed. To this list should be added the future ill effects of the perverse incentives under the Calman tax proposals which we have already discussed.

Under full independence, the Scottish Parliament and a Scottish government would be able to make different decisions in all of these areas. What is perfectly clear is that the choices made by a Scottish government under full independence would be different from those made by any UK government.

For a Scottish government operating under the White Paper version of independence, it is not clear how much freedom there would actually be to implement a truly independent fiscal policy. This is because the rules which Scotland would have to agree to as part of the price of membership of a currency union with the rest of the UK, (even assuming such an agreement were possible), are unknowable – but would certainly be stringent.

Natural resource management
We have already identified in this note the way in which Scotland’s natural resources are far from being managed and exploited optimally in Scotland’s interests. It would be a top priority for an independent Scotland to rectify this situation: both because the present situation is disgraceful in its own right, and also because a Scottish government would need to make better use of Scotland’s natural resources in order to secure Scotland’s fiscal position.

This is not to say, however, that a Scottish government would need to revert to the options either of nationalising natural resources, or of crudely increasing tax rates. It would be perfectly feasible, by appropriate use of licensing conditions, and suitable tax incentives, to make sure that a much greater proportion of the economic activity surrounding natural resource exploitation took place in Scotland: and likewise, that a higher proportion of the resulting profits remained here. (As one example, Scottish control of the seabed assets currently mismanaged by the crown estate would be a powerful lever.) Overall, the multiplier effects on Scottish GDP would in themselves substantially increase tax revenues.

A Scottish government operating under the White Paper version of independence is likely to find itself under considerable constraint on the extent to which it can take similar steps to improve Scotland’s management of its natural resources. For example, the fiscal conditions attaching to membership of UK monetary union are likely to limit the extent to which tax could be used innovatively.

Whisky
Similar considerations apply as for natural resources. In particular, there are existing arrangements for licensing distilleries: these could be used much more pro-actively
by an independent Scotland as a powerful means of ensuring more of the benefits of whisky stuck to Scotland. Such use of licensing conditions is likely to be available under both versions of independence.

Utility pricing
An independent Scotland would have the opportunity to correct the current, flawed, UK utility pricing model which results in over-charging and excess profits for privatised utilities: (see J. Cuthbert, 2012 and 2014, for a detailed critique of the current cost pricing model used by all UK regulators.) In fact, under devolution, the Scottish government could have already done this for the water industry in Scotland, (but not for the other utilities, which are regulated at UK level). Given the financial constraints of the devolution settlement, however, the Scottish government has found it more appropriate to continue with the flawed current cost pricing model for water, effectively using water charges as a concealed form of taxation. This is another example of how the unsatisfactory financing arrangements for devolution lead to sub-optimal decisions.

Under the White Paper version of independence, the situation is rather more complex. The White Paper envisages the continuation of the single GB wide market for electricity and gas, together with the current market trading arrangements. Within such a system, reform of the pricing models used is likely to require UK wide consensus, and may therefore be more difficult to achieve.

Other Areas
Our economic options paper also considered issues and policy options in a number of other areas: specifically, competition policy, public procurement, research and development, industrial policy and enterprise, higher education, social security, financial sector regulation and stability, employment policy, and skills for young people. In each of these areas, the options open to a Scottish government under full independence and under White paper independence would be broadly similar: so we have not thought it worthwhile to attempt to summarise here the material on these topics in our earlier paper.

References

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