Introduction

1. The Royal Society of Edinburgh welcomes the opportunity to submit a response to the Scottish Parliament's Finance and Constitution Committee inquiry into the potential differentiating effect in Scotland from Brexit.

2. The RSE has continued to be involved in activity regarding Brexit since well before the referendum. In advance to the referendum the RSE ran a series of events that addressed the main issues in the debate. After the decision to leave the EU in 2016, the RSE brought together an EU Strategy Group; the group is chaired by Sir John Elvidge and oversees the work of 4 Subgroups covering: Constitutional Law and Government; Economics and Public Finance; Research and Innovation; and Migration and Rights. The RSE intends that these groups will work to inform and engage in the debate around the withdrawal from the EU as negotiations develop. The RSE recently published ‘Brexit: Challenges and Opportunities’, this included 4 advice papers which came from the work of each subgroup The subgroups will continue to work to inform the debate as more information is made available through the negotiation period.

3. In preparing this response the RSE has drawn from the work of the Economy and Public Finance subgroup as well as drawing on expertise from the Society’s Fellowship and members from the Young Academy of Scotland. The Advice Paper has been approved by the General Secretary of the RSE, Professor Alan Alexander.

Are there any indications of a differential economic impact in Scotland separately from rUK?

4. Currently there are many uncertainties around the various features of the final Brexit settlement. This makes it difficult to identify the different potential effects on the Scottish economy. However, the Scottish economy's reliance on particular sectors and skills suggests that there could be a differential economic impact from Brexit on Scotland, as compared to the rest of the UK.

5. Given these uncertainties we strongly urge that the Scottish Government to use scenario planning to help predict the effects of Brexit rather than relying on point forecasts. Scotland’s Economic Strategy outlines the key growth sectors of the Scottish Economy including: Food and Drink, Creative Industries, Sustainable Tourism, Energy, Financial Services and Life Sciences. These are likely to be affected in different ways by Brexit. Scenario
planning might help Government, and others, to better understand the risks and challenges that the various sectors may face.

6. Scottish cities contribute heavily to the output of the Scottish economy. The economic importance of city regions has recently been recognised through the City Region Deals. Scottish cities have a critical role to play in determining the current and future size, scope and competiveness of the Scottish economy. Recent research has predicted that all UK cities will be negatively affected as a result of Brexit, due to higher trade costs and changes in the supply of key skills. Economic output in cities, measured through GVA, is predicted to be 1.2% lower on average in a ‘soft’ Brexit scenario and 2.3% lower on average under a ‘hard’ Brexit. All Scottish cities are likely to feel an economic impact from Brexit.

7. In Scotland, it is forecast that Aberdeen, Dundee, Edinburgh and Glasgow will experience the most negative effects on Gross Value Added (GVA). Aberdeen’s GVA is forecast to fall more than any other city in the UK, potentially experiencing an output loss of 4%. Edinburgh’s GVA is forecast to fall by 3%, while the forecast falls in Dundee and Glasgow are less pronounced at around 1.5-2.5%. The larger falls forecast for Aberdeen and Edinburgh stem from the reliance on knowledge-intensive services, particularly in oil and gas and the financial sector. The Scottish Government and the City Partnerships might wish to consider how these potential negative effects on output might best be ameliorated.

8. The Scottish Government has maintained clear population growth targets. Over the last decade the Scottish population has grown by 5% and now sits at a record 5.4 million. Growth in population is primarily due to migration rather than natural increase. Net migration to Scotland between 2015 and 2016 was 31,700. In these latest National Records Figures migration from the rest of the UK and from overseas are distinguished, but there is no distinction between migration from the EU and other international destinations. Brexit has caused uncertainty over future levels of migration to the UK and Scotland, with an expectation that net migration levels will be reduced. The latest data shows

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that migration from the EU to the UK has fallen since the decision to leave the EU in 2016. This is largely due to a decline in migration from Eastern Europe and an increase in EU nationals choosing to leave the UK. Net migration to the UK in 2016 was estimated to be 248,000, 84,000 lower than in 2015. Around 117,000 EU citizens left the UK while the number migrating to the UK fell by 43,0005. If the UK government’s aim is to reduce net migration to the “tens of thousands” post-Brexit, net migration to Scotland is likely to fall below 10,000.

9. Immigrants tend to be of working age. This is true for Scotland with 80% of EU nationals falling into this category6. The increase in the size of the working age population has slowed the ageing of the population in both Scotland and the UK. If there is a substantial decline in EU net migration post Brexit, the pace of population ageing will accelerate. The Registrar General for Scotland’s current central population projections predict that the number of pensioners will rise by 28% over the next 25 years, while the working age population will rise by only 1%7. Population ageing is predicted to progress more quickly in Scotland than in the UK as a whole, partly because migrants have disproportionately chosen to settle in England rather than Scotland.

What additional spending pressures are there on the public finances as a consequence of Brexit?

10. Brexit may also affect Scotland’s public finances. A continued fall in net migration will place pressure on Scotland’s tax revenues, primarily through falls in income tax and VAT receipts. The size of these falls is difficult to predict, given that there are no reliable data on the taxes paid by migrants to Scotland. Nonetheless, the Scottish Government or the Scottish Fiscal Commission might wish to commission some research on the revenue implications of reduced migration. The effects on welfare spending are likely to be small since the welfare powers being transferred to Scotland are mostly associated with disability and relatively few migrants are likely to claim such benefits, given that their overwhelming motive in moving to Scotland is to find employment. These effects will likely increase over time as the gap between Scotland’s actual population and that which would have emerged under continued free movement grows.

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11. Immigration data suggest that most immigrants who arrive in Scotland are relatively young. Young migrants help to support public services and businesses through employment. However, data from forecast income tax revenues indicate that age is one of the major determinants of tax take, with the bulk of income tax coming from the middle aged\(^8\). As young migrants are more likely to work in entry level jobs that usually are not in the top two tax rates, they do not, currently, make a significant difference to income tax revenues. Therefore a reduction in immigration is unlikely to have a major fiscal impact in the short term. However, in the longer term a reduction in migrant workers who may become higher-rate tax payers could have a greater impact. If Brexit does tighten the Scottish budget, this may place pressure on the Scottish Government to be more proactive in their use of the devolved income tax powers. Raising tax revenues will require the Scottish Government to target the top two income tax rates which would predominately affect a particular demographic.

12. If the UK economy does weaken as a result of Brexit, the UK Government may find itself under strong political pressure to adopt an expansionary fiscal policy to maintain output and employment. This could lead to an increase in funding to Scotland if the increased spending falls in areas such as health and education, which will result in Barnett consequentials for the Scottish budget. This may offset reductions in tax revenues caused by the negative fiscal effects of reduced migration on the working age population, but the longer term consequences of a post-Brexit fiscal expansion may be higher taxes and/or reduced spending in the future.

What should the Scottish Government’s priorities be in formulating Draft Budget 2018-19 in response to the initial economic impact of Brexit?

13. In the very short term there will be no major budgetary challenges from Brexit. Therefore it is unlikely that the Scottish Government will need to change its main priorities in formulating a Draft Budget for 2018-19. However, increased inflation, currently at 2.9%, resulting from sterling’s devaluation following the 2016 referendum will put general pressure on governments’ costs. The resultant falls in real wages are also likely to result in increased wage demands among public sector employees. Some of these may be difficult to resist, especially where staff shortages emerge due to public sector wages no longer being competitive with the private sector. These pressures will be heightened if public sector employers are no longer able to attract workers from other parts of the EU.

14. It is uncertain how much the UK will have to pay the EU in the proposed ‘divorce bill’. Current estimates put the potential bill at around £36bn. Payments to the EU as a consequence of Brexit will be paid from the overall UK budget which includes the budgets of the devolved administrations. Some payments to the EU have been incorporated in current fiscal plans since the UK expected to be a net contributor to the current EU budget which ends in 2020. If, however, additional payments form part of the final divorce bill, then there are likely to be consequences for the Scottish budget since cuts will likely be made in Barnett-related components of UK public spending.

Given that increased inflation is likely to disproportionately impact on the poorest, what measures should the Scottish Government take in its Budget to address this?

15. Following the decision to leave the EU and the consequent devaluation of sterling, inflation is currently at a four-year high. Its future path is uncertain. However, research by the Resolution Foundation indicates that inflation is now leading to reduced living standards. The research indicates that those on lower incomes are more likely to be affected by current increases in inflation because their typical consumption “basket” has been more affected by price increases.\footnote{Clarke, Stephen (2017) ‘Inflation Afflictions’. The Resolution Foundation, London. Accessed 11/08/17. URL: http://www.resolutionfoundation.org/media/blog/inflation-afflictions/}

16. The Scottish Government does not set the minimum wage. However, it has promoted the “Scottish Living Wage” in both the public and private sector. Efforts by the Scottish Government to promote improved wages for poorly paid workers helps mitigate the effects of inflation on living standards. On the other hand, its successful promotion within the public sector is likely to lead to increased costs and pressure on budgets unless compensating productivity increases can be achieved.

17. The devaluation of sterling has contributed to rising inflation, but it has also helped stimulate exports which have provided a modest boost to the UK economy in the short term. In Scotland, Sterling’s devaluation has been particularly beneficial to certain industries such as tourism and food production. Increased tax revenue from higher levels of output in these sectors will help offset some of the negative effects of Brexit described above.

What issues require to be considered from the loss of EU funding mechanisms arising from Brexit?

18. European Structural Funds and EU Research Funding have been beneficial to Scotland, supporting the development of key infrastructure, research and innovation. In Scotland there are some differences in the support provided by
the Structural Funds with the Highlands and Islands receiving the highest level of funding per capita. Post-Brexit the UK government may choose to maintain the levels of, and current distribution mechanisms, for these funds, thus allaying concerns from both the private and public sectors about the removal of such funding. Changes to the form and distribution of the funds are likely to be acceptable in the nations of the UK only if the UK Government is willing to negotiate in good faith with the devolved administrations.

19. The development of City Deal funding through the UK and Scottish Governments has opened a new stream of funding for city regions across the UK. Currently 3 city regions in Scotland have had their city deal packages approved by Government. The deals were planned before Brexit and have the clear objective of developing infrastructure projects as well as promoting private investment in the regions. Post-Brexit, the City Deal system might be used as an alternative channel to direct infrastructure and social funds across the UK, though this would likely have negative consequences for rural communities that are likely to be bypassed if the funding is largely directed towards cities.

20. There is uncertainty over the future of current funding that Scottish Universities receive from the EU; arguably this funding has been of particular benefit to Scotland through its support for research and innovation within the universities. Scotland has disproportionately benefited from research funding from the EU and EU students in comparison to the UK. If the UK withdraws from freedom of movement then it is likely that Scottish institutions will lose access to this funding stream. This withdrawal of EU research funding will provide challenges for both the UK and Scottish Governments, neither of whom will wish to see a decline in research and development activity. Both are likely to come under pressure from the higher education sector to find new avenues to support Scotland’s research infrastructure. If additional funding is made available it will be important to monitor how far it manages to replicate existing international research networks and enables researchers to work at arms-length from both the UK and Scottish governments.

Additional Information

This Advice Paper has been signed off by the General Secretary of the RSE.

Any enquiries about this response should be addressed to Paul Stuart, Policy Advice Officer (pstuart@therse.org.uk).

All responses are published on the RSE website (www.rse.org.uk).