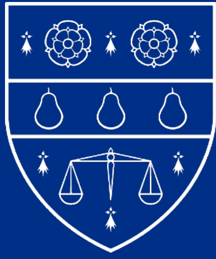

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CHALLENGES FOR THE SNP GROWTH COMMISSION

And four exam questions for their report

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24 May 2018

Working Paper 2018-05

A Gwilym Gibbon
Centre for Public Policy
Working Paper

Challenges for the SNP Growth Commission
And four exam questions for their report

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The Scottish National Party Growth Commission Report is to be published, after some delay, on 25 May. The SNP set up this body avowedly to address the shortcomings in the economic case for independence made in the 2014 White Paper. The report is a party political, rather than government, publication, but the Commission members include business and academic figures, led by the former SNP MSP Andrew Wilson. Its remit was

> "To assess projections for Scotland's economy and public finances, consider the implications for our economy and finances under different potential governance scenarios, and make recommendations for policy on:
>
> - Measures to boost economic growth and improve Scotland's public finances both now in the aftermath of the EU referendum and in the context of independence
> - The potential for and best use of savings from UK programmes in the event of independence, such as Trident
> - The range of transitional cost and benefits associated with independence and arrangements for dealing with future revenue windfalls, including future North Sea revenues.
>
> In addition, the Commission was asked to take account of the recommendations of the 2013 Fiscal Commission reports, and the outcome of the EU referendum, and consider the most appropriate monetary policy arrangements to underpin a programme for sustainable growth in an independent Scotland."

If there were ever to be another Scottish independence referendum, and *a fortiori* if Scotland were ever actually to become independent, a coherent economic strategy would be needed. This work is therefore to be welcomed (especially if it produces recommendations which could be implemented immediately). This paper however looks at the main economic issues which arose in the referendum campaign, and which have will have presented the Commission with challenges, and suggests how its report might be assessed against them.

Exam questions are set in each area.

1. Trade and the UK internal market

The 2014 case for independence was based on an independent Scotland and the United Kingdom both being members of the European Union. Whether an independent Scotland would be in fact a member was controverted at the time, but the boot is on the other foot now. Had membership been achieved, the border effects (customs, regulatory divergence, differing tax regimes, currency changes etc) which inhibit trade would have been ameliorated

by common membership of the EU single market and customs union. Nevertheless it was argued in 2014, using the Northern Ireland border as an example, that some border effects existed under shared EU membership – for example the need to account for value added tax separately.

The Growth Commission faces not merely that challenge, but the more difficult one that the United Kingdom will no longer be a member of the EU. If this is the case, and an independent Scotland seeks EU membership, then the Scotland -England border will be the external border of the European Union. Rules will be needed for customs, product checks, safety checks; for migration, for the EU's external security etc. These have been helpfully enumerated by the European Commission in the context of the Brexit negotiations.

The Growth Commission cannot ignore this set of issues. It may take for granted that Scotland will be a member of the EU, as that remains SNP policy. It may also take some comfort from the expectation that a solution of some sort will be found for the Irish border. That will (presumably) be guaranteed by agreement between the European Union and the UK because Ireland is an existing member state. It is not however be possible simply to assert that whatever solution is found will apply automatically to Scotland also, and in the absence of knowing the detail of that solution, the Growth Commission will presumably have to look at a range of possibilities for each of these, and address its potential effects on cross-border trade, given the enormous significance of such trade in the Scottish economy. Simply asserting that trade will continue unaffected will open the Commission to the same criticisms as the Leave campaign in the Brexit negotiations.

Exam question: Does the Report (a) acknowledge the economic problem of a border; (b) have a plan to deal with the UK being out of the EU; (c) assess the effect on Scotland-UK trade?

2. Currency and macroeconomic issues

The question of what currency an independent Scotland would use was a major issue in the 2014 referendum campaign and is for obvious reasons at the core of the Commission's remit. The White Paper based its position on advice from the Scottish government's panel of economic advisors, and asserted that as Sterling was the currency of Scotland inside the UK, Scotland would remain in a formal currency union with the UK. This was criticised as being more of a political than an economic proposal (polling showed losing the pound was unpopular with voters). Three major challenges were made to this position:

- it was argued that a currency union between independent states also required a fiscal union to deal with private-sector imbalances arising from differential economic growth. The example of Greece was used to point out that a country wanting to a currency union, unable to adjust its terms of trade by altering its exchange rate, and without substantial fiscal sharing could swiftly get into serious economic trouble. (The Governor of the Bank of England estimated that fiscal sharing of approximately 25% of GDP was necessary to ensure a stable currency union.)

- A currency union also implied a single monetary policy, which was unlikely to be suitable (notably in the absence of fiscal sharing) for two independent economies, and required an effective banking union. Again, the example of the European Monetary Union was used to make this point: European banking union is still under construction.

- In any event, the UK Chancellor said that the UK would not be willing to enter into such a continuing currency union, as it would not be in the best interests of either country in the absence of a concomitant fiscal and banking union. Whether economic arguments against were right or not, it would not have been possible for an independent Scotland to compel the rest of the United Kingdom to form a currency union with it.

In response to that last point, the SNP argued in the 2014 referendum that the United Kingdom could not prevent an independent Scotland using Sterling informally, a process sometimes known as "dollarization," under which a country simply uses another country's currency as a means of exchange etc. Examples are found in countries whose monetary system has failed, or where local currency is not wholly trusted.

The Scottish government's economic advisers had advised against "dollarization". A country which follows this approach has to accumulate sufficient currency within its territory to enable trade to take place. The consequence is that it is obliged to follow an extremely conservative fiscal policy – i.e. run a government surplus – in order to generate sufficient national savings to accumulate the necessary currency to enable the economy to run.

The 2014 White Paper did not address the main choice an independent country has about its currency – what exchange rate it should have with the rest of the world - and the implications of the choice. There are two broad choices: a fixed exchange rate (of which a currency union is the extreme example) and a floating exchange rate. A fixed exchange rate facilities trade as it gives exporters and importers of goods and services certainty about the prices which the can achieve in cross-border transactions. By contrast, a floating exchange rate, or one which can be altered, enables a country to deal with so-called asymmetric economic shocks – that is to say changes in its economic circumstances which differ from those affecting countries with which it trades – by adjusting the exchange rate.

A country which seeks to follow the wrong exchange rate policy can get into serious economic trouble – the UK shadowing the Euro during the period of the Exchange Rate Mechanism in the 1980s was a notorious example, and seriously damaged the Conservative party's reputation for economic competence. A country which cannot adjust its exchange rate in these circumstances may have to take drastic domestic measures to restore economic confidence. The UK collapsed out of the ERM, which entailed a marked devaluation. By contrast Ireland, locked into the Euro and therefore a fixed exchange rate had to undergo a prolonged period of domestic austerity.

In its approach to currency policy, the Growth Commission will be unrealistic if it fails to acknowledge that there is a trade-off between the benefits of a certain exchange rate for trade and the benefits of the floating exchange rate for macroeconomic stability. The

Commission may well reject the option of a sterling currency union entirely, and propose the creation of a new Scottish currency.

The currency and the fiscal policies of a small country are intertwined. Most small countries rum conservative fiscal policies, even accumulate surpluses, to enable them to absorb economic shocks and manage their currencies, especially of they try to run a fixed or partly fixed exchange rate. The 2014 White Paper ignored this point entirely, but the Commission should not.

As well as the question of exchange rate, major issues arise in how a new currency gets off the ground without creating economic disruption: new central banking arrangements have to be created, existing liabilities and assets have to be re-denominated, and the substantial risks of transition (that capital will flee the country) have to be managed: indeed very substantial resources have to be accumulated. All this happened in the Czech Republic and Slovakia in 1992. It would be unrealistic to expect a fully detailed plan from the Commission, but some acknowledgement beyond the bare assertion that this could take time is needed. The Commission will also have to address the question, in the circumstances, of how this was consistent with EU membership which involved a promise to join the Euro. It will be reasonable to expect a road map for the journey from a UK currency, to a Scottish one, and thence, presumably, to the Euro.

Exam question: Do the currency proposals (a) accept that currency union cannot be imposed on the UK; (b) have a consistent plan which acknowledges the trade-offs in fixed and floating exchange rates between trade and macroeconomic management; (c) make the connection with fiscal policy; (d) include a manageable road map from sterling to a new currency and thence to the Euro?

3. Fiscal issues

Perhaps the most challenging of all the economic questions faced by an independent Scotland is the balance of public expenditure and taxation. The Scottish economy at present runs a very substantial public sector deficit. It is proportionately very much more than the UK's: at £13.3bn if is 9.0% of GDP compared with 2.4% for the UK as a whole. Some of this is down to lower tax revenues, but it is largely because of unusually high levels of public spending. Spending by the Scottish Parliament on devolved services, which constitute around 60% of total public spending in Scotland is 25% a head higher than in England. This has emerged largely for historical reasons.

Obviously the question of oil revenues arises here. Offshore oil which would be in the Scottish sector were Scotland to be independent was a major source of revenue for the United Kingdom Exchequer most notably during the 1980s. The resource was applied to fund UK public expenditure. But at the same time Scottish public expenditure was determined (increasingly) by the Barnett formula which, together with inherited high levels of spending and relative population decline, has ensured the high levels of Scottish expenditure per head. In fact, taken over a prolonged period, additional public expenditure in Scotland compared with England has been of the same order as oil revenues, though there is no formal connection between them.

This issue was evaded in the 2014 White Paper which is simply looked at one year of public spending and revenue (2016-17) and made heroically high assumptions of oil revenue in that year in order to show that Scotland was in a strong fiscal position. In fact in the year in question actual oil revenues were markedly lower (£0.2bn rather than £2-4bn) than the unrealistic forecast. Looking forward, despite the recent rise of prices, oil revenues are not expected to be substantial.

The Commission therefore has to address the question of whether present levels of Scottish public spending could be funded under independence, and if so how. Simply asserting that growth itself will produce the necessary revenue will be unrealistic: economic activity would have to increase by approximately 20% per head in order to sustain the present levels of public spending at broadly present tax rates with a deficit level comparable to the UK's as a proportion of GDP. Running a conservative fiscal policy to support a new currency would mean even bigger cuts. The Commission's remit implies that it might simply argue that the abolition of the Trident nuclear weapons system will balance the books. This is hopelessly unrealistic. Scotland's per capita share of UK defence expenditure is under £3 billion per annum, so even abolishing all defence spending – Army, Air Force and the rest of the Navy as well as Trident – would reduce the deficit of £13bn by less than a quarter. The 2014 White Paper proposed abolishing Trident but identified defence savings of only £0.5bn.

The Commission should also address the question of the creditworthiness of an independent Scotland in the short and long run, and what fiscal policy it should run to maintain this. Many small countries run conservative fiscal policies to allow governments the scope to absorb economic shocks.

Exam question: Does the report have a fiscal strategy for Scotland that deals with both spending and taxation questions realistically so that an independent Scotland could manage its public finances in a creditworthy way? Or does it rely on non-existent oil revenues, imaginary spending reductions or wholly unrealistic growth predictions?

4. What sort of an economy?

Perhaps the biggest question of all is what sort of economy an independent Scotland should be. Is it to be Scandinavian, a high tax high spend economy with heavy investment in welfare producing economic success as well as reducing inequality? Or is it to be New Zealand, a low tax entrepreneurial state which secures growth in the long run? The 2014 White Paper allowed readers to believe both of these assertions simultaneously: if the Growth Commission is the same, it will not be credible. The Commission may argue that this is a choice for a future independent country. But that would be to evade the issue: these questions are to be answered to produce a plausible economic policy.

One focus of debate in 2014 was the argument that smaller countries are more likely to be economically successful simply because of their size. The Scottish government produced a selection of 6 small countries which it compared Scotland to, but analysis by the UK government appeared to show that some of those countries have done better in Scotland and some less well. It seems likely that the Growth Commission will do the same –identifying a

different selection. But an argument that being small will in itself produce growth is hardly likely to be convincing. Some small countries do indeed do better than Scotland, but some do not. What is needed the economic plan that suits the concrete circumstances of Scotland, and makes some reference to them.

Perhaps the most interesting question is whether some or all of the policies of the Growth Commission can be implemented without independence. Scotland's economic record over the last decade – after many decades in which it was relatively more successful than the rest of the UK – has been dismal. The Commissioner will have done some good if it identifies forces which can be implemented the powers already available to the Scottish government - and opponents of independence can hardly complain if any resultant economic success boosts support for it.

Exam question: Is there a coherent vision of what sort of economy Scotland should become, or is Scotland going to be Finland and New Zealand at the same time? What recommendations can be implemented now, within Holyrood's own powers?