Fiscal Autonomy

An Opportunity, Not a Threat

56 Scotland Means Business

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April 2015

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1 KEY POINTS

Analysis published by the Institute for Fiscal Studies (IFS) during the General Election campaign has identified a Scottish fiscal deficit, over and above the UK deficit, rising to £9.7 billion within five years.

This has been interpreted as evidence that fiscal autonomy is not feasible. However, the IFS analysis simply demonstrates that the current model is not working. An approach to managing the Scottish economy and public finances that delivers such a deficit is one that has failed and needs to be replaced by something else.

There are some issues with the assumptions that the IFS has explicitly or implicitly adopted in its analysis. These include the difficulties in forecasting oil prices and oil revenues (so if oil prices rise and revenues increase the deficit would be reduced or even eliminated), the failure to consider Scotland's historic net contribution to the UK's public finances and how some of the spending by the UK Government may no longer be necessary following fiscal autonomy.

However, the main issue with the IFS analysis is the assumption that fiscal autonomy would not result in Scotland improving its economic growth trajectory relative to the UK as a whole. There is considerable scope and opportunity to increase growth in the Scottish economy, with an economic strategy that is based on Scottish needs and opportunities and this would make a significant difference to public finances.

If Scottish economic growth can not be increased, that leaves two options to dealing with the fiscal gap identified by the IFS:

- a transfer of funds from the rest of the UK to Scotland; or
- cuts to public spending in Scotland: a £9.7 billion reduction would be the equivalent to around a quarter of total Scottish Government spending, over and above cuts already planned to UK spending.

At present it is difficult to imagine political circumstances arising that would make either of these options acceptable in both Scotland and in the rest of the UK. So, if fiscal autonomy for Scotland is not the right solution, there is an urgent need to identify some alternative.

Fiscal autonomy could create an environment in which the development and implementation of a comprehensive economic strategy based on a national collaborative approach, especially between public and private sectors, might be possible.

Increasing productivity to match the top quarter of advanced economies, increasing the employment rate to the average of the top five and halving the gap between UK and Scottish population growth, would almost double the size of the Scottish economy over 25 years. This would generate additional tax revenues to fill the identified fiscal gap five times over.

2 INTRODUCTION

2.1 N-56 Objectives

N-56 is an independent business organisation whose strategy is to promote an economic plan to elevate Scotland among the top 5 wealthiest and fairest nations in the world. Fundamental to that objective is the adoption of a national collaborative approach especially between public and private sectors.

The objectives of N-56 are to:

- provide an independent analysis of Scotland's economic performance and potential;
- promote a culture of collective strategic decision-making about what is best for Scotland's economy;
- raise the level of the debate on Scotland's economic future;
- ensure that the debate is open, inclusive and informed by a wide range of stakeholders;
- engage businesses from all sectors of Scotland's economy in the debate and bring focus to the importance of the private sector; and
- learn from international success stories.

These objectives are intended to ensure that the economic debate moves on from a discussion of economic powers for Scotland to also consider what should be done with those economic powers.

2.2 Previous Reports

N-56 published two major reports in June 2014:

- Scotland Means Business: The Facts, analysed issues such the UK's and Scotland's economic performance, public finances, the performance and economic policies of successful small advanced economies and the future potential of the Scottish economy, including growth sectors and factor conditions; and
- Scotland Means Business: The Strategy, set out a range of policy proposals and approaches to economic policy making that will help to ensure that Scotland can fulfil its potential as one of the best performing economies and societies in the world.

Copies of these reports are available at www.n-56.org as are the reports that have been published since then, covering the financial services sector, the oil and gas sector, infrastructure investment and export based growth.

In April 2015, N-56 published Invest for Growth, setting the need for a comprehensive strategy to address the needs and opportunities for the Scottish economy in the context of the UK's overall economic strategy.

2.3 Objectives of this Report

The No vote in the Independence Referendum in September 2014, followed by the rise in popularity of the SNP in Scotland has led to much commentary on what the fiscal and economic implications might be for greater devolution to the Scottish Parliament, in particular taxation powers, with Scotland remaining within the UK.

The model that has been at the centre of political debate has been the full devolution of tax powers to the Scottish Parliament so that the Scottish Government (or in the case of some taxes, local government) would be responsible for setting and collecting taxes in Scotland. Those taxation receipts would then be used to fund the spending of the Scottish Government (and local government) and the spending by the UK Government on behalf of Scotland on shared services (for example, defence, foreign affairs and any welfare or pension provision that remains reserved to Westminster). This model has been termed Full Fiscal Autonomy, Full Fiscal Responsibility and Devo Max.

Many of the criticisms that have been made of fiscal autonomy would also apply to other models of increased fiscal powers including those models where all levels of government would be responsible for setting and collecting the taxes required for their own spending. This model is usually known as Devo Plus or Home Rule.

Analysis that has been prepared by the Institute for Fiscal Studies (IFS) has suggested that if fiscal autonomy were to be implemented now, there would be a significant deficit in Scotland's public finances.

This paper considers the case that has been made against fiscal autonomy and considers what might happen if the proposals were implemented. The following issues are considered:

- Section 3 considers the political context, including whether it seems possible that the political circumstances will arise where fiscal autonomy for Scotland is seriously considered;
- Section 4 reviews the analysis provided by the IFS and critiques that analysis;
- Section 5 highlights important implementation issues that would need to be resolved;
- Section 6 asks what the alternatives to fiscal autonomy might be to resolve the deficit identified by the IFS; and
- Section 7 summarises the new economic strategy recommended by N-56 to generate greater economic growth and quantifies the potential scale of economic growth that such an approach could achieve, and the consequences for public finances.

3 POLITICAL CONTEXT

3.1 Westminster and Fiscal Autonomy

Much of the commentary about fiscal autonomy has been stimulated by the popularity of the SNP and the possibility that the party may be in a position of some influence if the UK General Election was to result in no overall majority for one party.

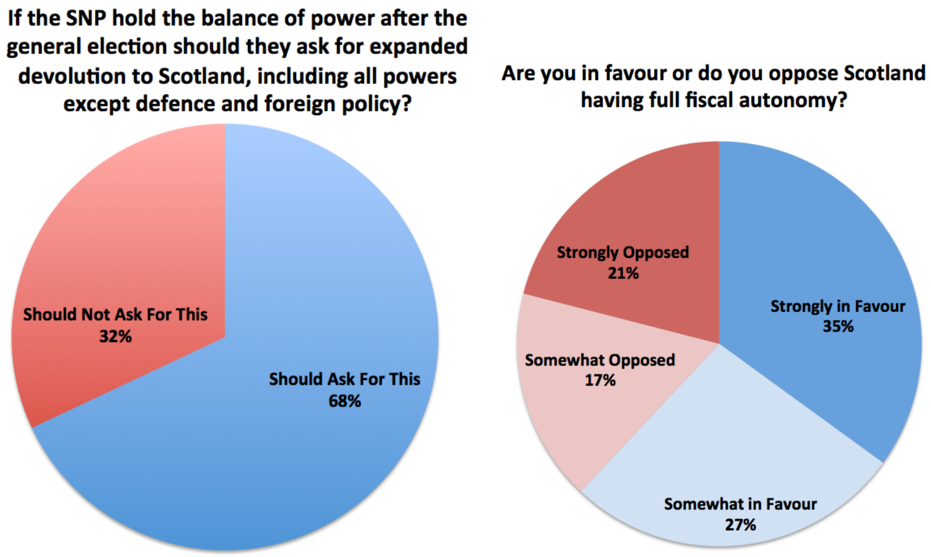
Fiscal autonomy would be a matter for the Westminster Parliament to address and so would require majority support in the House of Commons to pass the required legislation. The declared policy of both Conservative and Labour parties is against fiscal autonomy.

So, the current political context is that fiscal autonomy could not be legislated for unless at least one of the two largest parties at Westminster were to change their position. So, while fiscal autonomy may form part of the SNP's manifesto for the UK General Election, it can not be delivered without the agreement of either Labour or the Conservatives.

3.2 Public Opinion

More broadly, opinion polls in Scotland have for some time shown considerable support for fiscal autonomy.

Figure 3-1: Public Opinion on Fiscal Autonomy



Source: Opinion Poll Findings from whatscotlandthinks.org

One way to deliver fiscal autonomy is to devolve fiscal powers from Westminster to Holyrood. The danger for the unionist parties at Westminster is that if they fail to deliver fiscal powers through enhanced devolution, the Scottish voters may conclude that independence is the only way to ensure that the Scottish Parliament obtains significant powers over taxation, to go with the existing powers over spending.

4 SCOTLAND IN DEFICIT

4.1 The IFS Analysis

Much of the case against fiscal autonomy has been based on analysis published by the IFS, which has published two papers on the subject.

The first was based on analysis of the expenditure and revenue figures for Scotland for 2012-13 and the forward projections made by the Office for Budget Responsibility (OBR) for the UK as a whole to provide an estimate of the fiscal position that Scotland would be in for the current year, 2015-16, if Scotland was fiscally autonomous.

The headline from that first analysis was that Scotland would have a fiscal deficit (that is, a gap between taxation revenue and spending) of £7.6 billion for 2015-16, over and above the UK's existing deficit. The Scottish deficit, at 8.6% of gross domestic product (GDP) would be higher than the UK's at 4.0% of GDP.

Following the obvious criticism that this was a snapshot analysis for a single year, and that Scotland is not fiscally autonomous in 2015-16 (and even with full political will could not be, given that the year has already started), the IFS has since provided estimates for the next four years (Figure 4-1).

So, the IFS estimates that the Scottish deficit might be expected to grow in cash terms, but shrink as a proportion of GDP.

Figure 4-1: IFS Projections

Table 1: Net Fiscal Balance, UK and Scotland, 2013–14 (outturns), 2014-15 to 2019-20 (projections)

Net fiscal balance	*2013–14*	*2014-15*	*2015-16*	*2016–17*	*2017–18*	*2018-19*	*2019-20*
% of GDP							
Scotland	**-8.1%**	**-8.6%**	**-8.6%**	**-6.8%**	**-5.4%**	**-4.6%**	**-4.6%**
UK	**-5.6%**	**-5.0%**	**-4.0%**	**-2.0%**	**-0.6%**	**+0.2%**	**+0.3%**
Difference	**-2.5%**	**-3.7%**	**-4.6%**	**-4.8%**	**-4.8%**	**-4.8%**	**-4.9%**
Cash-terms difference	**-£3.8bn**	**-£5.9bn**	**-£7.6bn**	**-£8.2bn**	**-£8.5bn**	**-£8.9bn**	**-£9.7bn**

Source: IFS April 2015

4.2 Is Scotland Being Subsidised by the Rest of the UK?

The IFS analysis has led to some claims during the General Election campaign that Scottish public services are being subsidised by the rest of the UK. However, given that the UK as a whole also has a public sector deficit, as the IFS analysis shows, this is at best misleading.

The tax revenues collected from elsewhere in the UK are currently insufficient to fund public services in the rest of the UK and so there is no surplus available that can be used to subsidise public services in Scotland. So, what is in effect happening is that the UK Government is borrowing to fund the deficit in Scotland.

This means that UK borrowing is higher than it would have been without the Scottish deficit, in those years where there is a deficit. However, when oil prices have been higher, Scotland has tended to make a net contribution to UK public sector finances and, as the analysis below shows, over time the surpluses from Scotland have meant that UK deficits and debt are lower than they would otherwise have been.

4.3 Critique of IFS Approach

There is no doubt that the IFS has significant expertise in the area of public finances. However, the approach that has been taken could be described as an accountancy approach rather than an economic approach. The analysis does not fully take into account how the economy is not like a household or a business. In the economy, everything is connected (on person's spending is another's income), so one change will have multiple knock-on effects and the dynamic nature of the economy means that changes have cumulative effects over time.

The main issue with the IFS analysis is the assumption that fiscal autonomy would not result in Scotland improving its economic growth trajectory relative to the UK as a whole. There is considerable scope and opportunity to increase growth in the Scottish economy, with an economic strategy that is based on Scottish needs and opportunities and this would make a significant difference to public finances. This is discussed further in section 7 of this report.

There are also a number of other issues that the IFS analysis does not consider, including:

- the historical context, in particular, Scotland's long term net contribution to UK public finances;
- the difficulties associated with forecasting oil prices and oil revenues; and
- the nature of UK Government spending in and on behalf of Scotland and how this could change under fiscal autonomy.

Each of these is discussed further below.

4.4 Historical Context

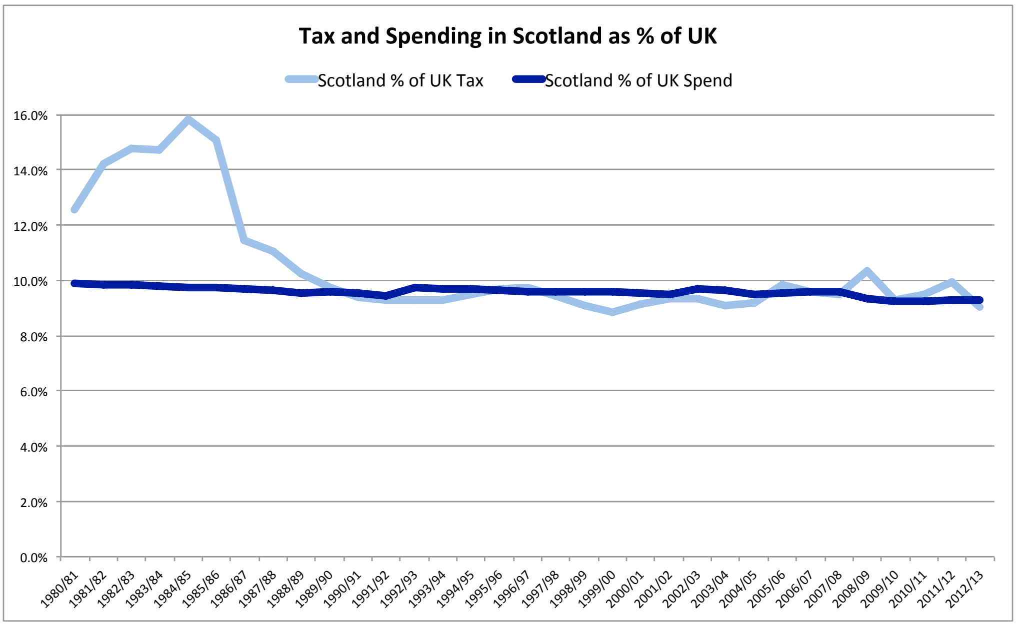
The IFS projections take the latest GERS statistics as their starting point. They were published in March 2015 and cover the year 2013-14, showing a larger net fiscal deficit for Scotland (8.1% of GDP) than for the UK as a whole (5.6% of GDP).

The figures for the previous year, 2012-13 also had a larger deficit for Scotland (9.7% of GDP) than for the UK as a whole, while in the year before that the Scottish deficit (5.9% of GDP) was lower than the UK deficit (6.9% of GDP).

However, a decision such as devolving substantial taxation powers to the Scottish Parliament should take account of longer term trends. Data on Scotland's net fiscal balances are available for the period 1980-81 to 2012-13. In the 1980s Scotland made a large net contribution to UK public finances and since then Scotland's share of UK tax revenues has been very similar to Scotland's share of UK public spending (Figure 4-2).

On average, since 1980-81, Scotland, with 8.3% of the UK's population, has received 9.6% of UK government spending and has been the source of 10.5% of UK taxation revenues.

Figure 4-2: Scotland's Share of UK Tax Receipts and Public Spending since 1980



Source: GERS 2012-13, Scottish National Accounts Project (Historic Fiscal Balances)

4.4.1 Scotland's Net Contribution to UK Public Finances

The level of UK government debt has increased from £113.8 billion in 1980-81 to £1,258 billion (£1.40 trillion) in March 2015 (£22,000 per person) and is forecast to increase to more than £1.65 trillion by 2018-19[1].

However, over the period for which data is available (from 1980-81 to 2012-13), Scotland's net fiscal balance has generally been far healthier than that of the UK.

[1] Office of Budget Responsibility Economic and Fiscal Outlook, March 2015
[2] Office of Budget Responsibility Economic and Fiscal Outlook, March 2015

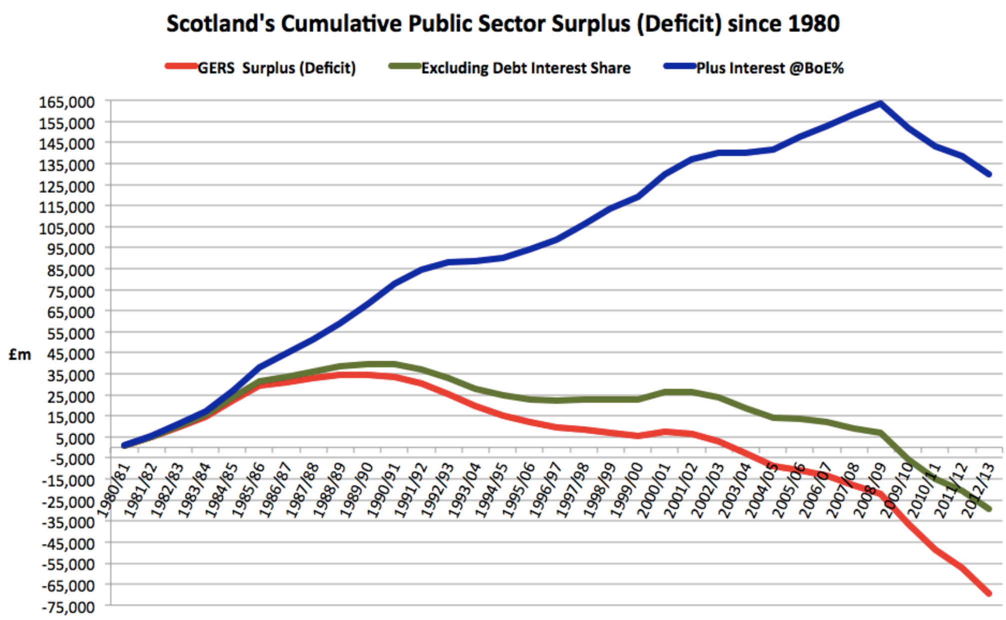
Based on the figure from GERS, as a result of the impact of the financial crisis on the public finances, the net position for Scotland by 2012-13 would have been a deficit of £61 billion (the red line on Figure 4-3). This is equivalent to 42% of Scottish GDP; the UK debt at the end of 2012-13 was equivalent to 80% of GDP.

However, these calculations include a Scottish per capita contribution to meeting public sector debt interest payments. While this might be a reasonable statistical assumption to make, it does not reflect the fiscal position of Scotland. If public sector debt interest payments are excluded (other than those that relate to the debt that already existed in 1980-81), Scotland's net fiscal deficit in 2012-13 reduces to £21 billion, just 15% of GDP (the green line on Figure 4-3).

Even this understates the relative health of Scottish public finances. Had the substantial fiscal surpluses in the 1980s been invested in a stabilisation fund (a sovereign wealth fund), interest could have been earned and a substantial fund built up as a hedge against tough economic conditions, such as those being faced currently.

The blue line on Figure 4-3 shows what Scotland's cumulative government surplus would have been had separate public sector accounts been maintained. This includes interest on net surpluses, based in the Bank of England base rate, giving an accumulated net surplus of £130 billion in 2012-13 (down from a peak of £164 billion), equivalent to 88% of GDP, around £25,000 per person.

Figure 4-3 – Scottish Public Finances Cumulative Surplus



Source: Calculations based on GERS 2012-13, Scottish National Accounts Project (Historic Fiscal Balances)

In the event of fiscal autonomy, it would seem reasonable for the Scottish Government to argue that this historical contribution should be recognised when negotiating what the starting point should be. Given the current state of UK public finances it is probably unrealistic to expect Scotland to be credited with the cumulative surplus of £130 billion.

An alternative approach would be to deduct contributions to debt interest and debt repayment from Scotland's contribution to UK wide expenditure.

The Office of Budget Responsibility puts UK net debt interest payments at £36.1 billion per annum in 2013-14 and forecasts this to rise to £51.1 billion in 2019-20. Scotland's per capita share of that would more than £4.3 billion. This is almost half of the fiscal gap identified by the IFS.

In addition, current UK Government fiscal plans are to generate a fiscal surplus by 2019-20 and so be in a position to start the process of repaying debt.

4.5 Oil Prices

The projections for oil revenue have been based on projections made by the OBR. In March 2015 the OBR was assuming that oil prices would increase from $55 per barrel in early 2015 to $71 per barrel by early 2017 and then stay at this level until at least 2020[2].

However, oil prices are notoriously difficult to forecast and the OBR (and the Treasury before it) does not have a good track record in forecasting oil prices. Indeed, as recently as March 2014 OBR forecasts were based on a price of $100 per barrel to 2020.

While oil prices fell to less than $47 per barrel in January 2015, they had increased to around $65 per barrel by April 2015, a significant difference in the context of the UK oil and gas sector because the unit technical cost of production in 2014 was $48.20 in the North Sea[3].

In November 2014 OPEC predicted that the long run oil price would be $100 per barrel to 2040[4]. This estimate was based on the cost of supplying the marginal barrel of oil, which has risen considerably in the past decade and doubled between 2004 and 2008.

If this were the case then the long term prospects for the UK oil and gas sector will be considerably brighter than many have feared in the early months of 2015.

This would also make a significant difference to Scotland's fiscal position, and could lead to a return to surpluses.

Moreover, the devolution of substantial fiscal powers to the Scottish Parliament would mean that oil and gas revenues would make a proportionately greater contribution to public finances than is currently the case for the UK as a whole. The Scottish Government would

[2] Office of Budget Responsibility Economic and Fiscal Outlook, March 2015
[3] Oil and Gas UK, *Activity Survey 2015,* 2015
[4] OPEC, 2014 World Oil Outlook, November 2014

therefore be motivated to take a keener interest in the prospects for the sector, ensuring that a comprehensive strategy was in place that maximise its economic contribution, as has been the case in Norway. The policy measures in Norway have included incentives to encourage exploration and investment in research and development.

4.6 UK Government Expenditure on Behalf of Scotland

The IFS analysis covers both spending by the Scottish Government and the spending of the UK Government in and on behalf of Scotland. Total public spending for Scotland in 2013-14 was £66.4 billion. Of this, £40.8 billion was spending by the Scottish Government (and local government) with the other £25.6 billion (38.5% of the total) spending by the UK Government for and on behalf of Scotland.

However, this is based on the current model of devolution. Some of the current spending by the UK Government for and on behalf of Scotland may no longer be required after fiscal autonomy.

A large proportion, some £16.7 billion of the total spending of £25.6 billion by the UK Government for and on behalf of Scotland is on social protection, which includes welfare and pensions.

The spending on debt interest repayments is discussed above. However, there are also other elements of UK Government spending that may no longer be necessary or where savings could be made, including in public administration, some aspects of economic affairs and cultural spending.

4.7 The Current System is Not Working, So Nothing Should Change

Whilst the IFS analysis has been used as a basis of a critique of proposals for fiscal autonomy, the findings should be regarded instead as an indictment of the current model. The assumptions are based on 2012-13 expenditure and revenue figures (and so reflect the current model where fiscal powers are almost all held at Westminster) and the projections made by the OBR for the UK economy (and so, again, implicitly assume that there will be no improvement in the performance of the Scottish economy relative to that of the UK as a whole).

So to argue that the deficits projected by the IFS are a case against change is to argue that the current system is not working, so it should not change.

Scotland is an advanced economy that has been producing oil for more than 40 years, with associated significant contributions to UK tax revenues. However, unlike almost every other oil producing country and region, the UK has failed to establish a fund to ensure that funds are in place to cover deficits in years when oil prices, and so taxation revenues from the oil and gas sector, fall below long term trend levels.

Moreover, the management of the Scottish economy by the UK

Government, which retains many reserved powers that are important to a strategy for economic growth, has failed to deliver public finances in Scotland to provide the infrastructure and other conditions for economic growth and to provide public services that meet public expectations.

So, the current deficit in Scottish public finances, far from being a case against change, demonstrates the necessity to move to a model that delivers better results for Scotland, and for the rest of the UK.

5 IMPLEMENTATION ISSUES

There are a number of implementation issues that would need to be addressed in advance of fiscal autonomy for Scotland. A few of the most important are highlighted below.

5.1 UK Spending

Analysis of government expenditure and revenue in Scotland is currently based on a statistical analysis that is undertaken after the fact. The most recent analysis[5] was published in March 2015 and covers the financial year 2013-14. Many of the figures contained in that analysis are estimates, particularly in the areas of spending by the UK Government.

This is because UK Government expenditure is not generally monitored on a geographic basis and there is no distinction between spending that benefits the UK as a whole and spending that is for the benefit of only a part of the UK.

Fiscal autonomy would involve the Scottish Government paying the UK Government a block grant each year to cover a share of expenditure that is undertaken for the UK as a whole.

This would require a distinction to be introduced into UK public accounting so that UK spending could be distinguished from spending on only a part of the UK, specifically English spending. A similar distinction would also be necessary for other models such as Home Rule or DevoPlus.

This distinction would allow fiscal autonomy to be introduced for Scotland even if it was not introduced for other parts of the UK.

While this may seem straightforward, it would involve negotiation. Some areas of spending, such as defence and foreign affairs would be obvious areas for agreement since they are clearly UK spending. However, others such as infrastructure spending in London or major investments such as the Olympics may be more difficult to reach agreement on.

5.2 Fiscal Autonomy is not Independence

The assumption that has often been made in commentary on fiscal autonomy and interpretation of the IFS analysis is that there would cease to be any transfer of resources between the constituent parts of the UK.

However, fiscal autonomy is not independence and Scotland would remain part of the UK. In other countries where there are devolved fiscal powers, there are agreements in place that transfer resources from wealthier to poorer regions.

5 Government Expenditure and Revenue in Scotland 2013-15, Scottish Government, March 2015.

The implications for Scotland and the UK would be that Scotland would be expected to make a net contribution to the rest of the UK when the economy and public finances were in a relatively healthy state and, in return, could expect a resource transfer in the other direction in the event of relatively poor performance.

This is an issue that has rarely been discussed in the UK and would need to be resolved as part of the implementation of a fiscal autonomy model. Principles would need to be agreed on how such a model would work. It would need to avoid the problem of moral hazard, where one part of the UK might feel that they could be bailed out by another part of the UK if mistakes were made that led to poor performance.

5.3 Borrowing Powers

Fiscal autonomy would also require borrowing powers to be devolved so that the Scottish Government could manage variation in tax revenues and make investment decisions that could generate longer term economic growth.

However, as any debt issued would be sovereign debt, or at least would be considered to be sovereign debt by financial markets, rules would need to be agreed with the UK Government on the levels of borrowing and debt that would be acceptable.

5.4 Implementation Timescales

Fiscal autonomy would also require new institutions to be set up, although these could be based on existing institutions in some cases.

There is some recent precedent for how long it can take to devolve fiscal powers within the UK. The Calman Commission was set up in 2007 and the income tax powers that it recommended for devolution to Scotland will be implemented in 2016, some nine years later.

However, with political will, it should be possible to implement fiscal autonomy on a shorter timescale. Perhaps the four year period between the passing of the Scotland Act 2012 and the new income tax powers in 2016 provides a better target timescale.

6 ALTERNATIVES TO FISCAL AUTONOMY

The fiscal gap that has been identified by the IFS analysis has been presented as an impediment to fiscal autonomy. As previously discussed, the fiscal gap is the outcome predicted based on continuing with the current model.

The question that arises fro those who have opposed fiscal autonomy is, if fiscal autonomy does not provide the basis for addressing this situation, what are the alternatives?

There is no Scottish or regional dimension to UK economic strategy and none of the major political parties has proposed to change that during the General Election campaign.

So, if the powers to stimulate economic growth are not to be devolved to Scotland, that leaves few options to dealing with the fiscal gap identified by the IFS. These are:

- a transfer of funds from the rest of the UK to Scotland. While the UK as a whole remains in fiscal deficit this would mean additional borrowing and if the UK was to move to a fiscal surplus, this would mean taxation revenues collected from elsewhere in the UK being transferred to fund public spending in Scotland; or
- cuts to public spending in Scotland. The scale of this would need to be substantial since a £9.7 billion reduction would be the equivalent to around a quarter of total Scottish Government spending, over and above cuts already planned to UK spending.

At present it is difficult to imagine political circumstances arising that would make either of these options acceptable in both Scotland and in the rest of the UK.

So, if fiscal autonomy for Scotland is not the right solution, there is an urgent need to identify some alternative.

7 FISCAL AUTONOMY AND A NEW ECONOMIC STRATEGY

N-56 has recommended the development and implementation of a comprehensive economic strategy that can elevate Scotland among the top 5 wealthiest and fairest nations in the world. Fundamental to that objective is the adoption of a national collaborative approach especially between public and private sectors.

Such an approach does not require fiscal autonomy. An alternative would be for the UK and Scottish Government's to collaborate, together and with the private sector, on the development and implementation of an economic strategy that was based on the needs and opportunities for the Scottish economy.

However, fiscal autonomy would mean that most of the policy tools relevant to economic growth would have been devolved to the Scottish Government and so a collaborative approach could be easier in practice.

Detailed recommendations have been made in previous N-56 reports. What a comprehensive strategy might include is summarised below.

7.1 Comprehensive Strategy

A comprehensive strategy to increase economic growth, and address inequality, can be achieved through a set of policies that are designed to:

- increase economic participation: to match the employment rate of the top five advanced economies; and
- deliver export-based growth: increase Scotland's trade volumes to match the average for small advanced economies.

A range of mutually reinforcing transformational strategies has been suggested by N-56 in the Scotland Means Business reports, as a starting point for the development and implementation of a new economic strategy. These include:

- Exports: a new exports strategy including development of a Scottish brand, enhancing the productivity of exporters, learning from success stories such as oil services and whisky on sales and distribution channel development;
- Infrastructure: a new national development plan, including a substantial investment in infrastructure, which could be funded by a Scottish infrastructure bond, available on international bond markets and as a long term savings product in Scotland;
- Renewables: realising the economic opportunities by commercialising new generation technologies such as wave and tidal power, for global markets, as the Danes have done in wind turbines, including developing co-investment models;

- Frankfurt of the North: support for the financial services sector where long term growth opportunities exist, including the global growth markets for fund management. Measures include consistent regulatory and fiscal regimes, supporting innovation and skills development;
- Growth Sectors: strategies to build competitive advantage in a range of other sectors where global growth niches exist, including tourism, transport, food and drink, creative industries, life sciences, universities and healthy ageing;
- Energy: building on the recommendations of the Wood Review, a range policy measures in support of the oil and gas sector, including exploration incentives, ensuring fiscal stability, stimulating R&D and investment, incentives for the relocation of corporate headquarters to Scotland, education and skills initiatives and development of the Scottish engineering brand;
- Human Capital: continued investment in the education sector including taking advantage of the highly skilled workforce that is associated with Scotland's university and college system and labour market initiatives to promote high economic participation;
- Innovation: protecting investment in the existing innovation system and efforts to promote entrepreneurship to build longer term competitiveness in emerging sectors in the UK economy, including mechanisms to facilitate the provision of expansion capital, for long term growth;
- Entrepreneurship: ensuring that public policy is supportive of business-led advice and support initiatives, including a tax system with low business compliance costs and incentives for investment in new businesses; and
- Taxation system: reforming the tax system that applies in Scotland, based on the Mirrlees recommendations for a simpler tax system. The reforms will learn lessons from others that have simplified their tax systems such as the New Zealand.

The new economic strategy should be at the top of the hierarchy of policy, providing a framework for all other areas of policy and ensuring integration across all areas of policy.

7.2 Impact of Growth

In 2013-14, the GDP of the Scottish economy was £152 billion and so Scotland accounted for 8.8% of the UK economy (which had a GDP of £1,733 billion). Scotland has 8.3% of the UK population so GDP per capita in Scotland was higher than for the UK.

However, when compared with more successful advanced economies a number of gaps in performance can be identified:

- **participation**: while Scotland has a higher employment rate than the UK as a whole, at 69.4% of the 15-64 population, it is only 14th in the OECD. If Scotland was to match the average of the top five (Iceland, Switzerland, Norway, Netherlands and Sweden), that would require 7.5% increase in the rate, requiring a 10% increase in the number of jobs in the economy;

- **productivity**: Scotland is currently in the third quartile of OECD countries for productivity, measured by GDP per hour worked (on an index where the United States is 100, Germany is 92.7 and Scotland is 78.4; comparator economies, with higher levels of trade include Norway at 137.8, Luxembourg at 129.7, Ireland at 112.6, Switzerland at 89.1, Denmark at 88.8, Sweden at 85.9, Austria at 85.6 and Finland at 79.8). Scotland would require a 15.5% increase in productivity to be in the top quartile of OECD countries;

- **population**: the Scottish population has been static while more successful economies such as Norway and Denmark have experienced population growth. If Scotland had matched UK population trends since 1951 the Scottish population would be 1.3 million higher than it is. Over the next 25 years, the Scottish population is forecast to grow by less than 9%, compared with a 15% projection for the UK as a whole;

- **trade**: even if trade with the rest of the UK is included in Scottish trade figures, Scotland's trade per capita of $55,800 is well short of the $75,000 average for a small advanced economy. Scotland's trade volumes would need to increase by a third to match the average for small advanced economies and, if oil and gas exports were excluded, Scottish trade would need to increase by 60% to match competitors, some £94 billion in additional trade.

Population trends and employment rates are also correlated with economic growth. Trends in working age population, productivity and economic participation have a significant combined effect on economic performance over time.

Scottish population forecasts show an ageing population with a small drop in the working age population. This means that, with no increase in productivity and no increase in the employment rate, there would be a small decline in GDP in Scotland, by 1%, over the next 25 years and a decline in GDP per capita of 9%.

However, even if the Scottish economy continued to underperform relative to competitors, some productivity growth would be expected. Based on trend productivity levels (growth of around 0.6% per annum less than the average for small advanced economies), but no change to population trends or the employment rate, GDP would increase by a about a third to £192 billion, increasing GDP per capita by 22% to more than £33,000.

Increasing productivity, population trends and the employment rate would all increase economic growth:

- productivity: increasing productivity to match the top quarter of advanced economies would increase GDP to £222 billion, a 54% increase over 25 years and GDP per capita by 41%, to more than £38,000 (an increase in output per person of £6,500 more than current trends would achieve);
- participation: increasing the employment rate to the average of the top five advanced economies (from 71% to 80%) would generate more than half a million jobs in the Scottish economy and increase GDP to £218 billion, a 51% increase over 25 years and GDP per capita by 38%, to almost £38,000; and
- population: halving the gap between UK and Scottish population growth (increasing to 6.11 million from 5.31 million in 2012, equivalent to 330,000 more people than current projections predict, mostly of working age people, retained in Scotland and attracted to move to Scotland by a growing economy) would increase GDP to £204 billion, a 41% increase over 25 years and GDP per capita by 26%, to more than £34,000.

The transformational strategies set out would be expected to deliver a mix of productivity growth, population growth and an increase in the economic participation rate.

Increasing productivity to match the top quarter of advanced economies, increasing the employment rate to the average of the top five and halving the gap between UK and Scottish population growth, would increase GDP from the baseline of £153 billion in 2012 to £282 billion, an 86% increase over 25 years.

This would also increase GDP per capita by two-thirds, by more than £18,000, from around £27,000 to more than £45,000.

This economic growth would be good for Scotland. It would also be good for the UK economy because it would help re-balance the economy, providing a counter-balance to the economic activity in London and the South East of England.

7.3 Public Finance Projections

Increasing the size of the Scottish economy would be expected to considerably improve the state of public finances. There would be two main effects on public finances:

- additional GDP would mean additional taxation revenues from growing companies and more and higher earning employees; and
- improved economic performance would reduce the demand for some public services, particularly those associated with economic under-performance (for example, unemployment benefit).

In 2013-14 total tax revenues collected from Scotland were £54 billion and total GDP was £153 billion and so taxation revenues were equivalent to 35% of GDP. It would be reasonable to expect that the tax revenues associated with growth would be equal to at least 35% of the additional GDP (and this could be an underestimate given the economic baseline conditions in 2013-14). In addition, savings of the order of 5% of GDP might be expected as a result of lower demand for some public spending.

So, an increase in GDP of £129 billion might be expected to result in an improvement in public finances of some £52 billion per year. This projection is based on a long term growth strategy and so would deliver additional revenue gradually over a 25 year period. However, it provides some context for how economic growth could eliminate the Scottish public sector deficit identified by the IFS.

N-56 aims to provide a new focus for Scotland's business community to work with government and others throughout the country, to plan a more prosperous future for the whole of Scottish society.

The ultimate aim is to ensure that Scotland attains a position among the top five advanced economies in the world.

If you would like to learn more about N-56, its aims and activities, please visit our website **www.N-56.org**

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