these ISLANDS

Response to the Sustainable Growth Commission

July 2018

Kevin Hague

"This is a very helpful and objective analysis of the Growth Commission report's attempts to side step key issues regarding the macroeconomics of independence. The report is astonishingly silent on how the proposed fixed exchange rate regime would handle macroeconomic shocks, be they oil, financial or external to the Scottish economy. There is no discussion of how an independent Scotland would accumulate the massive reserve holdings it would need for a country at its level of development and to ensure a credible currency regime and provide deposit insurance for the banking system. It also kicks into the long grass how the many billions of pounds of cross border assets and liabilities would be redenominated once the country moves to its own currency. As Kevin Hague's paper points out, the Growth report is a recipe for an almost never ending dose of austerity the likes of which Scotland has never seen. It's very unclear why such a proposal could be attractive to the Scottish electorate." – **Professor Ronald MacDonald**, Research Professor of Macroeconomics and International Finance (Economics), Adam Smith Business School, University of Glasgow

"The Growth Commission seems to rely on an overly optimistic economic assessment. The reality is that the links between Scotland and the UK are much deeper that those between the UK and the EU. So the pain for Scotland of leaving the UK - certainly in terms of trade but so much more - would be commensurately larger. The Commission fails to address the economic price Scots would be asked to pay should they opt to leave the UK and prefer the EU. Furthermore to prosper an independent Scotland would need financial stability, and to achieve this will be a significantly greater challenge than the Commission seems to recognise" – **Sir Andrew Large**, Formerly Deputy Governor for Financial Stability of the Bank of England and member of the Monetary Policy Committee

"The SNP's Growth Commission deserves careful and critical scrutiny, as we have to assume it would be the economic plan of an independent Scotland, and this paper is an important contribution. It points to key gaps in the Growth Commission work, notably growth targets that are no more than aspirations to be as rich as some other small countries. As this paper points out, the Commission's fiscal rules are internally incoherent, and imply not just continuing but increasing austerity on public spending. The imaginary oil revenue the 2014 White Paper is replaced by imaginary revenue growth and, as Scotland would be hoping to borrow very large sums to replace the support it presently gets from the UK, amassing a debt burden which will eat up the budgets for public services." – **Professor Jim Gallagher**, Visiting Professor, University of Glasgow, Associate Member, Nuffield College, Oxford

“This important paper constructively examines the recommendations of the Growth Commission by taking a thorough look at the numbers. What emerges is in fact a strong, positive argument for the continuation of the UK as the best solution for the Scottish economy. This chimes with my view that, from a financial services perspective, the Growth Commission’s comments on banking, financial regulation and resolution effectively amount to a ringing endorsement of the current UK system.” – **Brian Quinn CBE**, Former Honorary Professor of Economics, Glasgow University and Former Acting Deputy Governor of the Bank of England

"I fully concur with this paper's evidence-based analysis and critique of the underlying economic and spending assumptions and conclusions offered in the Sustainable Growth Commission report" – **Professor Brian Ashcroft**, Emeritus Professor in Economics, University of Strathclyde

About The Author

Kevin Hague co-founded and is currently Chairman of These Islands. As an entrepreneur he has co-founded, invested in and acted as an executive Director of two successful Scottish businesses (M8 Group Ltd and Endura Ltd). He has held various Non-Executive Director and corporate advisory positions, and is currently Executive Chairman of M8 Group. He has gained a reputation for robust analysis of Scotland’s economy through his “Chokkablog” blog and often appears in the Scottish media commentating on politics and economics. He was previously Partner and Finance Director at OC&C Strategy Consultants.

These Islands is a think tank and forum that stands unabashedly for the view that more unites the three nations of Great Britain than divides them, and that good relations between the various communities of Northern Ireland, Great Britain, and Ireland are all the more important to work for in the wake of Brexit.

One of These Islands’ driving objectives is to facilitate informed and constructive debate by ensuring facts are honestly presented and that any analyses used are both robust and appropriately interpreted.

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Executive Summary

In 2013 the Scottish Government's Independence White Paper assumed an independent Scotland would be able to retain Sterling as part of a formal currency union and could rely on future oil revenues to deliver fiscal sustainability. During the 2014 referendum the UK government rejected the idea of a currency union and we now know that in 2016-17, when the White Paper forecast oil revenues of £6.8bn – £7.9bn, the actual figure was just £0.2bn.

Faced with understandable accusations that their previous economic case for independence was a 'false prospectus', in 2016 the SNP established a Growth Commission. Their objective: to create a credible economic case for independence by showing how faster growth of Scotland's onshore economy could fill the income gap left by declining offshore revenues. This paper is an initial response to the Growth Commission's report.

The Growth Commission have succeeded in taking forward the debate about how Scotland's onshore economy could be improved. They make well-argued cases for the economic value of greater immigration, the potential for stronger export growth, the importance of improving productivity, the need for infrastructure investment and the opportunities that should arise from developing digital and technological skills, creating a more entrepreneurial culture and driving innovation. There are many ideas in the report that can be adopted without any need for Scotland to become independent and we believe these should be the subject of ongoing, constructive and non-partisan debate.

In contrast to their positive suggestions for growth, when we study the report's quantitative claims we find ourselves questioning whether the authors' desire to make a case for independence has compromised the quality of their analysis. The Commission has singularly failed to make a coherent economic case for independence; in fact their work helps highlight the economic benefits of Scotland remaining part of the UK.

To justify ambitious growth targets, the Commission cherry-picks a set of better performing small advanced economies (SAEs). By the simple expedient of excluding SAEs with materially lower GDP/capita than Scotland, they are then able to make the unsurprising observation that Scotland's GDP/Capita is lower than the median.

Faster growing SAEs who rely on low-tax, high income-inequality models (which the Commission explicitly rejects) are included in the calculation used to justify the growth rate target they suggest Scotland should, after 10 years, aspire to match. The Commission then simply asserts that an independent Scotland should aim to outperform this growth rate by a further 1% pa for fully 15 years.

There is nothing wrong with ambition, but these growth aspirations are beyond anything that the empirical data can support. In fact, the specific countries the

Commission suggests Scotland should most seek to emulate (Denmark, Finland and New Zealand) do not demonstrate materially faster growth than the UK at all.

To calculate an economic starting position, the Commission accepts the base level of spending in Scotland projected for 2021/22. By not proposing to reverse any spending cuts, they tacitly accept that the current austerity policies they claim to reject are in fact necessary (but not sufficient) to put Scotland on a path to a fiscally sustainable position.

Assumptions are made about debt allocation and savings from shared UK costs that are objectively more optimistic than those made in the 2013 White Paper. Net savings assumed then were £0.6bn pa; the Commission now assumes 'day one' savings of £2.6bn. This figure is arrived at by a combination of sweeping assertion, 'rounding-up', double-counting and – most worryingly of all – an obvious error in the way the underlying GERS data is interpreted.

The Commission discusses at length the likely negative economic consequences of Brexit, but simply ignores the equivalent economic damage that would be caused by Scotland leaving its far deeper and more significant union: the United Kingdom. Given that Scotland trades 3.6x more with the rest of the UK than with the EU – and the implications of this for Scottish jobs and economic performance – the Commission's failure to consider the potential impact of trade-friction with the rest of the UK, or broader economic shocks caused by separation, is an extraordinary and indefensible oversight.

Add to all of the above its assumption that the transition costs for creating an independent nation would be less than the latest estimate for the costs of taking on a handful of welfare powers devolved from Westminster, and it's clear that the economic starting point used by the Growth Commission is most definitely not based on *"very conservative assumptions"* as they claim.

The report states its aspiration as being to paint a picture of hope that is *"grounded in a clear-sighted reality and a rigorous plan"*. A plan that makes transparently optimistic assumptions and simply ignores the downsides of its proposals cannot be considered to be either clear-sighted or rigorous.

The Commission also fails to consider which of its recommendations for growth could be pursued without the need for the trauma of separation from the UK. Failure to consider and seek to learn from alternative economic models that do not presuppose independence is a major shortcoming of the report. An economic case for independence that ignores the fact that many of the benefits it includes do not require independence is no economic case at all.

Recognising the need to demonstrate fiscal credibility, the Commission goes on to recommend that an independent Scotland's first Fiscal Rule should be to deliver a deficit of less than 3% of GDP within 10 years, and that this should be achieved through spending restraint.

Based on the comparisons the Commission makes with other SAEs, this fiscal rule is not sufficiently aggressive. Certainly if Scotland were to meet the Commission's aspirations to launch its own independent currency, reaching a fiscal surplus would be a more credible aim.

Despite making unrealistic starting assumptions, ignoring any of the downsides of separation from the UK and suggesting a relatively modest first Fiscal Rule, the Commission is unable to avoid concluding that an independent Scotland would require at least a decade of spending restraint. Based on realistic growth assumptions, this would translate into even greater austerity than Scotland has seen in recent years.

If the Commission's model for deficit reduction had been applied over the last decade, Scotland would have spent about £60 billion less and in 2016-17 public spending would have been £8bn (12%) lower.

The Growth Commission itself illustrates that Scotland outside the UK would face a decade of further spending restraint just to (hopefully) get the deficit down to 2.6% – a figure still worse than the UK's deficit which Scotland shares today.

The Commission doesn't attempt to model the economic impact of its laundry-list of tentative recommendations. It recommends GDP growth be stimulated by migration driven increases in population, but by not putting any figure on the population growth expected it leaves us unable to form any view on the implications for GDP *per Capita* growth (a measure the Commission rightly highlights as being more important to citizens of a country than total GDP growth alone).

The longer term growth targets the Commission proposes appear to be what would be required over a 25-year time frame for GDP growth alone to replace the fiscal transfer Scotland currently receives from the rest of the UK.

The deficit gap that today is met by the Barnett Formula and that the 2013 White Paper assumed would be filled with North Sea revenues, the Growth Commission now assumes will be filled with revenue resulting from highly speculative and frankly unjustifiable GDP growth rate assumptions.

The Commission accepts that their currency proposal of sterlingisation *"for a possibly extended transition period"* would be damaging to Scotland's financial services sector and avoids discussing how or when an independent Scotland might qualify for EU membership.

When the Commission refers to Scotland's *"under-performing position"* as a motivation for change, it's referring to Scotland's deficit performance rather than its economic output. The Commission accepts that Scotland as part of the United Kingdom is *"without question a rich and successful nation"* with *"economic performance […]*

amongst the best performing decile in the world" and that "*Scotland's economic output per head is the best of the UK nations and regions, outside of London and the South East"*. It follows that Scotland only 'under-performs' on a deficit per head basis because of its higher spending per head. This higher spending is made possible by UK-wide pooling and sharing, because the whole of the UK needs to be fiscally sustainable, individual parts do not. Whether this higher spending is due to structural reasons and/or how an independent Scotland might reduce identifiable per capita spending is an issue the Commission simply chooses to ignore.

The net effect of all this is that the Commission has helped us see how being in the UK allows Scotland: to enjoy the advantages of a shared currency and large domestic market; to avoid the fiscal constraints that would inevitably apply were Scotland a stand-alone economy; and to benefit from levels of public spending that would otherwise be unsustainable.

The evidence that Scotland would achieve faster economic growth just by dint of becoming an independent small advanced economy is tenuous at best – particularly as the cost of independence would be at least a decade of fiscal restraint which would very likely dampen growth. However, the Growth Commission's report does contain the kernel of a more attractive strategy than separation from the UK.

The Growth Commission report illustrates many of the downsides of independence while highlighting (albeit reluctantly) the economic benefits of our inevitably flawed but enduring 300 year-old union. An approach which seeks to grow Scotland's economy by constructively building on the strengths of this union would seem to us favourable to one that seeks to destroy it.

Using the devolved powers Scotland already has (or may develop) to pursue the Commission's growth ideas without creating the unnecessary disruption, uncertainty and further austerity that separation from the UK would entail would be a logical and constructive way of taking forward their work.

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Context

In November 2013 the Scottish Government published a white paper entitled "Scotland's Future: Your Guide to an Independent Scotland".[1] This presented an economic case for independence that relied on retaining Sterling as part of a formal Sterling Area with the UK and depended on future oil revenues to deliver fiscal sustainability. During the 2014 independence referendum the UK Government rejected the idea of a formal currency union and North Sea revenues have since collapsed. The White Paper predicted oil revenues in 2016-17 of £6.8bn – £7.9bn pa[2], the actual figure turned out to be £0.2bn.[3]

Faced with accusations that they had previously campaigned on a 'false prospectus', in September 2016 the SNP announced the formation of a Growth Commission, tasked with building a "sound, transparent and firm prospectus"[4] for independence. Former SNP MSP Andrew Wilson was appointed as Chair and in March 2017 he declared the report was "due to be delivered to the First Minister in the coming weeks"[5].

Rebranded as the "Sustainable Growth Commission", the report was finally published at the end of May 2018, a year later than originally planned. It is worth noting that despite the lack of any overt SNP branding, the Growth Commission is an SNP party funded document, not an official government White Paper.

These Islands was formed in recognition of the fact the case for maintaining the union must be about much more than narrow economic arguments, but also that if we are to have an informed and constructive debate about our future then any economic arguments must be fairly and honestly presented. It is in that spirit that this response is offered.

[1] Scotland's Future
[2] Scotland's Future, p.75
[3] GERS 2016-17
[4] https://inews.co.uk/news/politics/snp-unveils-group-advise-independent-scotlands-currency/
[5] https://www.bbc.co.uk/news/uk-scotland-scotland-politics-39178324

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Response

At over 119,000 words the Commission's report is undeniably a substantial piece of work. These Islands welcomes the report as a thoughtful and fact-based contribution to the wider constitutional debate.

The Commission has taken its time, consulted widely[6] and as a result has given us much to digest. We too should take our time, so what follows is no more than an initial response. The topics of currency and debt settlement are two in particular we expect to address with separate papers in time.

It is a sad indictment of the state of economic debate in Scotland that we feel the need to applaud the Commission for accepting and building on the Scottish Government's own Government Expenditure and Revenue Scotland (GERS) figures. We hope that those commentators and politicians who have sought to undermine this National Statistics publication will take note. The Growth Commission have rightly recognised that any serious discussion of Scotland's economic position must start with the GERS figures.

We welcome the Commission's efforts to advance the debate about how best to grow Scotland's economy by looking internationally for examples of best practice. The report presents well-argued cases for the economic value of greater immigration, the potential for stronger export growth, the importance of improving productivity, the need for infrastructure investment and the opportunities that should arise from developing digital and technological skills, creating a more entrepreneurial culture and driving innovation. There are many ideas in the report that can be taken forward without any need for Scotland to become independent and we believe these should be the subject of ongoing, constructive and non-partisan debate.

The report suggests that *"it is essential to stimulate an inclusive, national debate on Scotland's economic future to find out whether a different, better path is possible."*[7] These Islands shares this aspiration for an inclusive debate, but we also seek to ensure that any debate is well-informed and open-minded.

The Commission's report presupposes that any future path must involve separation from the UK. The report does not argue the case for independence, it assumes independence as the answer and then tries to deal with the issues that assumption creates. In that regard this report is a political document, thinly disguised as an objective analysis.

An *inclusive* national debate must surely at least consider the views of the majority of Scots who rejected independence in 2014 (and who polls tell us continue to reject independence today).

[6] Although we note with disappointment that Trade Unions were not included in the consultation
[7] 3.38 (p.17)

There are paths other than independence which the Commission has ignored. No attempt has been made to learn from the many different regional, provincial and state models that exist.[8] We recognise the difficulty in finding comparable data at a sub-national level, but don't see why this should constrain our thinking. Failure to consider and seek to learn from alternative economic models that do not presuppose independence is a major shortcoming of the report.

When we study the detail of the report – particularly its quantitative claims – we find ourselves questioning whether the report's authors' desire to make a case for independence has compromised the quality of their analysis.

It is in the spirit of seeking to ensure that any debate stimulated by the report is well-informed that in this paper we make the following 9 observations (each of which is expanded on in the chapters which follow):

1. **Smaller isn't Necessarily Better**: The report does not make a case for small advanced economies being intrinsically superior to larger ones
    a. All the analyses offered around the performance of Small Advanced Economies (SAEs) compared to Large Advanced Economies (LAEs) are based on a sample of *the most successful* SAEs only.
    a. The report doesn't seek to gain insight or learn lessons from the experiences of less successful SAEs (such as Greece or Portugal).
    b. This approach makes sense when seeking to identify those successful SAEs from whom we might seek to learn, but it offers only a partial perspective and prevents us drawing any conclusions about SAEs *in general*.

2. **Stretching the Empirical Data:** The 'growth potential' claims made are unrealistic
    a. The £4,100 figure used to scale the potential increase in GDP/Capita is based on no more than saying 'if we had the same GDP/capita as the Netherlands we'd have £4,100 more GDP/capita'.
    b. The report concludes that Scotland should aspire to 0.7% pa higher GDP growth as a result of becoming an SAE – but the 0.7% figure relies on including in the benchmark group of SAEs countries like Hong Kong and Singapore whose low tax, high income-inequality models the Commission explicitly rejects.
    c. The report goes on to recommend that Scotland should set as a goal the aim of exceeding this SAE growth rate by a further 1.0% pa for fully 15 years. No empirical evidence is offered to suggest that this is a realistic aspiration.

[8] Germany, Canada and the US being just three obvious examples

d. The report assumes that country size is the main explainer of observed differences in performance, but makes no attempt to prove this or to test alternative hypotheses.
e. The growth potential claims made take no account of the specific policies and strategies the Commission actually recommends.
f. The particular countries the Commission recommends we most seek to emulate have not demonstrated materially superior growth to LAEs (such as the UK).

3. **Failing to Make a Case:** The report does not make a case for independence
    a. The report implicitly attributes all of the speculative upside it identifies to the 'case for independence', despite observing that many of the recommendations could be implemented using existing or enhanced devolved powers.
    b. Failure to compare the projections made for independence with an alternative 'use the powers we have' scenario is a striking omission.
    c. The report completely fails to consider any of the potential downsides of independence such as trade-friction with the rest of the UK or broader economic shocks caused by separation.

4. **A Reality Check**: Far from being more realistic, the report is objectively more optimistic than the 2014 White Paper
    a. The report assumes 'day 1' net savings of £2.6bn whereas the 2014 White Paper assumed net savings of just £0.6bn.
    b. The assumptions behind this £2.6bn net saving are not just extremely optimistic, some of the calculations involved are simply wrong and lead to the figure being clearly and significantly over-stated.
    c. The 2014 White Paper assumed Scotland would inherit a "negotiated and agreed"[9] apportionment of UK debt. The Commission makes the more optimistic assumption that – by negotiating a debt servicing cost and calling it part of a 'solidarity payment' – an independent Scotland would be considered as starting 'debt free' from a market (and EU) perspective.[10] It is far from clear that this attempt to move the debt 'off balance-sheet' would work as the Commission hopes.
    d. The Commission suggest 'total set-up costs' would be £450m. The author of that claim has previously stated the 'total transition costs' would actually lie in a range of £0.6bn to £1.5bn.[11] The set-up costs just for the

[9] Scotland's Future p.21
[10] It also says they *"assume that credit markets will consider the impact of the Annual Solidarity Payment when assessing Scotland's creditworthiness."* [B3.33] but they ignore the implied debt figure when later calculating debt/GDP ratios
[11] http://blogs.lse.ac.uk/politicsandpolicy/a-debate-about-scotlands-transition-costs-a-response-to-mcleans-critique/

limited welfare powers being devolved as a result of the Smith Commission proposals are already expected to be up to £660m.[12] A figure of £450m for the total set-up costs for an independent Scotland is patently unrealistic.

e. The report claims that the 5.5% 'legacy deficit' they project has been arrived at using *"very conservative assumptions".*[13] Based on the observations above, we do not see how that statement can possibly be justified.
f. We note that the Commission assumes all of these speculative savings would have to be used to reduce the deficit, rather than for any increases in public spending in other areas.
g. The Commission's +0.7% pa higher real GDP growth rate ambition seems more optimistic than the 2014 White Paper's +0.12% pa higher GDP *per capita* growth observation.[14]
h. Exclusion of oil revenues from the calculations is an explicitly conservative assumption but, given Scotland's oil revenues have cumulatively totalled less than £0.3bn over the last 2 years[15], not enough to off-set the optimism we've seen above.
i. By avoiding discussion of North Sea oil[16], the Commission avoids consideration of future oil and gas decommissioning liabilities, which are estimated at £40bn – £80bn.[17]
j. Ignoring North Sea oil seems like a convenient symbolic gesture aimed at distancing the Growth Commission from the 2014 White Paper (which forecast £6.8bn – £7.9bn pa of offshore receipts[18]).

5. **The Truth about Austerity**: Claims that the economic model proposed is 'anti-austerity' do not stand up to scrutiny
    a. Ensuring the deficit is reduced to below 3% within 10 years is the Commission's first Fiscal Rule.[19]

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[12] https://firstminister.gov.scot/letter-to-the-prime-minister/
[13] 3.144
[14] It's impossible to draw a direct comparison because the Commission make no attempt to project population figures and therefore offer us no projections for GDP per capita – but Scotland's population growth rate over the last 25 years has averaged just 0.25%, over the last decade 0.50%
[15] According to GERS, Scotland's share of N Sea revenues was £56m in 2015-16, £208m in 2016-17
[16] Apart from the surprising insinuation that the UK Government was at fault when it reduced the tax burden on this ailing sector (something the SNP actively called for): *"However, the UK's oil and gas tax receipts have also fallen due to policy decisions taken by the UK Government on the taxation of the sector, for example on tax rates (including setting the rate of petroleum revenue tax at zero in March 201615) and tax allowances associated with investment."* [B4.15]
[17] http://www.if.org.uk/wp-content/uploads/2018/04/North_Sea_Decomissioning_Press_Release_.pdf
[18] Scotland's Future, p.75
[19] B12.2 and repeated in various forms more than 10 times within the report

b. The model suggested for achieving this is for growth in spending to be sufficiently lower than growth in GDP so as to reduce the deficit to less than 3% within 10 years.
c. Based on their optimistic starting assumptions (see point 4 above), the Commission illustrates that spending growth of 1% less than GDP growth would deliver a deficit of below 3% after 9 years.[20] This can only lead to real increases in spending if real GDP growth is greater than 1%.
d. Over the last 10 years Scotland's real onshore GDP growth has averaged 0.8% pa.[21] The Scottish Fiscal Commission's latest forecasts[22] are for real GDP growth to not exceed 0.9% pa in the foreseeable future.
e. Whether looking back at the last 10 years or forwards based on realistic growth rate forecasts, the combination of the Growth Commission's first Fiscal Rule and their proposed model for reducing the deficit implies real spending reductions.
f. The Commission states within the body of the report "*we recommend modest real terms increases in public sector expenditure"*[23]*,* but this can only be achieved (while holding to their first Fiscal Rule) if real GDP growth is greater than 1% pa.[24]
g. The Commission's model implies significantly greater austerity than the current 'UK austerity model' they claim to reject. If applied over the last 10 years, we conservatively[25] calculate that the Growth Commission's recommendations would have led to roughly £60bn less public spending in Scotland over that period, and a 12% reduction to spending in 2016-17.[26]
h. By not seeking to reverse recent austerity cuts on independence[27], the Commission tacitly accepts that the austerity Scotland is currently enduring is a necessary (but not sufficient) condition to make the Scottish economy fiscally sustainable on a stand-alone basis.
i. A corollary of the above is that the Commission makes no allowance for spending increases to reverse such inherited policies as the benefits cap, the 2-child tax credit cap or increases in the state pension age.

[20] Assuming constant revenue/GDP and a starting deficit of 5.9%
[21] Using 2016-17 GERS figures and applying the HMT GDP deflator
[22] The forecast runs to 2023, at which point 0.9% real GDP growth is forecast http://www.fiscalcommission.scot/media/1300/scotlands-economic-and-fiscal-forecasts-may-2018-full-report.pdf
[23] B12.16 being the only time this 'recommendation' is mentioned, although Part B recommendation 42 does state "at *trend rates of growth and inflation this would allow annual average cash increase of above inflation"*
[24] And if we accept the optimistic 'legacy deficit' starting position
[25] Our calculation is conservative as it doesn't assume any reduction in revenue generation despite reduced expenditure (the fiscal multiplier effect) – the Commission itself recognises this risk when it observes that when budgets are cut *"there is a risk that a counter-productive impact on growth can result" [B1.8]*
[26] This is not a surprising finding given that the Commission's first Fiscal Rule means the spending reduction over the decade would have to be enough to get the deficit below 3% by the end of that period
[27] In fact the Commission explicitly states "*Scotland's replication of UK budget spend currently allocated to Scotland in a number of areas is assumed to be unchanged for our analysis including welfare, pensions, economic development and scientific and university research funding."* [Part B, p.17]

j. We note that the alternative strategy of hoping that increased spending will act as a fiscal stimulus to drive growth is hardly mentioned in the report. It appears only as a rather equivocal and non-committal final recommendation[28] (and is not modelled at all).
k. The commission has claimed to reject the existing 'austerity model' but has replaced it with one that is necessarily harsher. *Necessarily* so because – unlike the situation for Scotland remaining within the UK – the Commission suggests than an independent Scotland would *have* to get its deficit below 3% within a decade.[29]
l. In summary: The anti-austerity rhetoric is completely disconnected from the detail of the report's recommendations. We are not alone in drawing this conclusion – commentators and analysts from across the political spectrum (many of whom are in favour of independence) share our view.

6. **Aiming Too Low**: The Commission's first Fiscal Rule (to get below a 3% deficit within a decade) is not sufficiently aggressive
    a. The report notes that *"Small advanced economies have made fiscal prudence a strategic priority"*[30] and none of the Commission's chosen SAEs runs a deficit as large as 3% – most in fact run a surplus.[31]
    b. The report notes[32] that for the three countries it suggests we most seek to emulate[33], Finland targets a deficit of <u>1.0%</u> of GDP, Denmark a deficit of <u>0.5%</u> and New Zealand seeks to maintain a <u>surplus.</u>
    c. The IFS, with customary understatement, have observed that *"A deficit of almost 2.6% of GDP might be sustainable for a large country with good growth and a long track record of borrowing on international markets. For a new and relatively small country it may not."*[34]
    d. The European Fiscal Compact specifies a <u>0.5%</u> deficit limit *"as measured across the cycle"*.[35]
    e. The report itself observes that a sensible long term fiscal target should be *"<u>fiscal balance</u> over the business cycle"* or *"if a 2% GDP growth rate can be sustained, then a deficit limit of around <u>1% of GDP</u> may be appropriate in the longer term".*[36]

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[28] *"Transitionary Fiscal Stimulus: a fiscal stimulus to growth should be considered and consulted on depending on the prevailing economic circumstances and the perspectives and price required by debt providers."* [B14.1, recommendation 43]
[29] The report states *"the imperative to do this is real"* [B7.7] – but only the assumption of independence makes this so
[30] A3.32
[31] Figure 7-1
[32] Figure 8-1
[33] 3.58 (p.19) *"we are especially drawn to a hybrid of Denmark, Finland and New Zealand"*
[34] https://www.ifs.org.uk/publications/13072
[35] B7.11
[36] B8.67

f. The Commission aspires for Scotland to achieve EU membership[37], for which having an independent currency is effectively a prerequisite.[38] Building the necessary reserves to support an independent currency would almost certainly require an independent Scotland to run a fiscal surplus.
g. All of the report's analysis assumes that, by calling the cost of servicing Scotland's inherited share of the UK's debt a 'solidarity payment', the markets will consider an independent Scotland to be starting 'debt free'. This is unrealistic: we would expect the bond market to view the 'solidarity payment' as what it is: a debt servicing cost.
h. We would therefore argue that, to show how an independent Scotland could be fiscally sustainable, the Growth Commission needs to demonstrate how it could move into surplus. In fact, using extremely optimistic assumptions and after fully 10 years of independence (and likely austerity), the Commission still projects a deficit of 2.6%.[39]

7. **The Missing Model:** The report doesn't attempt to model the likely impact of its recommendations
    a. The "Framework & Strategy" outlined in Part B of the report is less a strategy, more a laundry-list of possible ideas and process recommendations.[40]
    b. The report is long on process. It recommends seven separate Reviews[41], five new Agencies[42], three further Commissions[43], two new Institutions[44] and a National Brand Strategy.
    c. When it comes to actual policy recommendations, the report mainly talks in broad, unquantified terms. The costs associated with implementing policy suggestions are seldom if ever considered, the likely scale of any economic impact is rarely quantified.

[37] B8.63
[38] The formally stated economic accession criteria is *"a functioning market economy and the capacity to cope with competition and market forces"* https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/accession-criteria_en
[39] Figure 12-2
[40] Which build on the process recommendations made in Part A
[41] Universities Growth Strategy Review, Government Led Innovation Review, Comprehensive Review of Scottish Taxation System, Comprehensive Review of Inherited UK Spending Programmes, Standing Council on Scottish Public Sector Financial Performance, National Balance Sheet Review and a Comprehensive Review of policy relating to long-term risk bearing projects
[42] Inward Investment Agency, Innovation Agency, Economic & Fiscal Forecasting Agency, Asset & Liability Management Office and an agency "*tasked with creating a strategy for engagement and transitioning of the staff of international governments and multi-national organisations to Scotland*"
[43] Productivity Commission, Infrastructure Commission, Gender Pay Equality Commission
[44] The Scottish Central Bank and a Scottish Financial Authority

d. Some of the possible building blocks may have been discussed, but a strategy that would meet the report's aspiration of *"Bridging the gap between potential and performance"*[45] has not been constructed.
e. The report does not make growth assumptions, it merely asserts some "ambitious growth goals"[46] (which it does not then go on to model).[47]
f. These 'goals' are unjustifiably ambitious. Not only do they assume that an independent Scotland would grow at rates defined by reference to 'peer group' countries that include high growth, low tax, high income-inequality models the Commission rejects, they actually suggest that an independent Scotland would *outperform* those countries by a further 1% pa (in GDP growth rate terms) for fully 15 years.
g. These 'ambitious growth goals' appear to have been chosen because they would, by implication, roughly close the gap in GDP per capita between Scotland and the Netherlands over a 25 year period – but this is only true if there is no differential in rate of population growth.
h. The Growth Commission recommends accelerating population growth as a *"top priority"*[48], but offers no estimate of the increase in rate of population growth they either aspire to or expect. If incremental improvement in GDP is driven by incremental increase in population, the rate of improvement in GDP per Capita will necessarily be less than the rate of improvement in GDP.
i. This is an extremely significant point. The report observes that *"The overall level of GDP in a country is less important to individuals than the level of GDP per capita."*[49], but we are left unable to judge what even the Commission's 'aspirational' goals would deliver in terms of GDP/Capita improvement.

8. **Currency – an Unsolved Conundrum:** The report's currency recommendation is symptomatic of the weakness of the economic case for independence
    a. Even with all of its optimistic assumptions and despite recommending (implicitly at least) greater austerity than Scotland has experienced in recent years, the Commission fails to show how Scotland could get to the fiscal surplus that would almost certainly be required to create an independent currency.

[45] 2.8
[46] 3.98, recommendation 1
[47] The exception to this is when the Commission does make growth assumptions when attempting to illustrate how deficit reduction through spending discipline could still lead to real spending growth: *"At Scotland's long-term trend GDP growth rate of 1.5%, and inflation at 2%, this would mean that nominal increases in public spending of 2.5% would reduce the inherited deficit from 5.9% of GDP to less than 3.0% of GDP by year 9"* [3.192]. The assumptions used in this example are not the same as the 'growth goals' later defined.
[48] "*The attraction of economic migrants (from identified target groups) should be one of the top priorities of Scottish Government economic policy*."
[49] A1.41

b. The Commission therefore has little choice but to recommend *"that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period".*[50]
c. Whilst this strategy of 'sterlingisation' may be the most pragmatic solution to the currency problem that independence would create, it would necessarily constrain an independent Scotland's economic freedom
d. The Growth Commission makes a point of singing the praises of Scotland's Financial Services sector[51] – a sector which employs over 190,000 people in Scotland – but appears to accept that the inevitable loss of large parts of this sector in Scotland would be an acceptable (but unquantified) price to pay for independence.[52]
e. The Growth Commission makes no attempt to quantify the reserves that would need to be accrued before being able to consider creating an independent currency.[53]
f. Not having a stable, independent currency would at the very least hamper an independent Scotland's attempts to join the EU. The Commission does not address this issue.

9. **Making the Case for Union:** The Commission, by implication, makes a strong case for Scotland staying in the UK
    a. The report notes that smaller economies are more volatile and must be more fiscally conservative than large economies[54] and recognises that an independent Scotland would not be able to sustain a deficit of greater than 3% for more than a decade.
    b. The report also makes the point that the UK – as a *large* advanced economy – *has* been able run relatively large deficits over the last decade.[55]

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[50] C1.7
[51] *"The financial services sector in Scotland has a long history and global reputation, particularly in high value areas such as insurance and asset management."* [A1.13]
[52] *"Financial support would not extend to holding companies of retail banks […] It is likely that the result would be that some companies would move their domicile to England in response, in expectation of broader support from the Bank of England. […] Indeed most, if not all, of the banks have already made clear in public statements that they would be headquartered in London for the purposes of regulation in the event of independence."*[C3.28]
[53] The report simply suggests the following as one of its six tests for establishing an independent currency *"Sufficiency of foreign exchange and financial reserves: Does Scotland have sufficient reserves to allow currency management?"* [C2.6.4]
[54] *"The greater volatility that small economies can experience also strengthens the case for fiscal Conservatism"* [B8.33]
[55] The report states [B3.134] *"[…] it is anticipated on the basis of OBR and other independent forecasts that the GERS estimate of Scotland's deficit would be 7.1% of GDP by 2021-22. This would have to come down. However, it should be noted the UK has had a deficit at or above this level in six of the last ten years."* Using the GERS figures, that statement is in fact true for five of the last ten years (08/09 – 12/13), but the point stands

c. Not only are the fiscal constraints less onerous for large economies, but regions of a larger economy are able to benefit from the average performance of the whole. Not every part of the UK has to be fiscally sustainable on a stand-alone basis, only the whole of the UK does.
d. By staying in the UK, Scotland would benefit from the spending freedom that having a deficit as low as 0.7%[56] creates. The Growth Commission helpfully illustrates that Scotland outside the UK would face another decade of further spending restraint just to (hopefully) get the deficit down to 2.6% – a figure still worse than the UK's deficit which Scotland shares today.[57]
e. That Scotland currently benefits from UK-wide pooling and sharing is beyond dispute. The GERS figures show Scotland currently receives an effective fiscal transfer from the rest of the UK of £9bn – 10bn pa.[58]
f. It is surely no coincidence that the growth in GDP per capita the Commission aspires to would have a revenue impact of £9bn pa.[59] The Commission's optimistic assumptions imply it would take 25 years to get there – so optimistically 25 years to maybe replace the fiscal transfer Scotland would be guaranteed to lose on day one.
g. The Growth Commission attempts to suggest this fiscal transfer and Scotland's greater deficit is evidence of 'under-performance' on Scotland's part[60], an assertion they undermine with their own observation that *"Scotland's economic output per head is the best of the UK nations and regions, outside of London and the South East."*[61]
h. The reason for this apparent contradiction is that Scotland's 'performance' in terms of onshore revenue generation per capita is broadly in line with the rest of the UK, the 'under-performance' the Commission refers to is based on the observed GERS deficit, which is explained primarily by Scotland's higher public expenditure per capita.
i. Given that higher per capita spending is the main reason for the 'under-performance', we find it odd that the Commission imply this is somehow the fault of the current constitutional settlement.
j. The Commission makes no attempt to suggest that independence would change Scotland's per capita spending in any of the areas where it's

[56] As the IFS forecast for the UK in 2021/22
[57] 2016-17 GERS deficit for total UK is 2.4%
[58] See later chapters for a full discussion of these figures
[59] 3.32
[60] *"In political terms, we present a choice for making Scotland's public finances sustainable, purposefully and by our own efforts. It is for others to then judge whether this is preferable to having them ordered in the same manner that got us to the current under-performing position in the first place."* [B1.15]
[61] A1.64

higher than the rest of the UK, but they do allude to the fact that the causes may be structural.[62]

k. An important principle of pooling and sharing is that high 'cost-to-serve' areas are subsidised by lower 'cost-to-serve' areas. Scotland – with its low population density, remote and island communities and challenging demographics[63] – benefits from this principle within the UK (via the Barnett Formula).
l. It's a simple statement of fact that separation from the UK would reduce the size of Scottish companies' domestic market by 90%.[64] The downside of this is noted by the Commission when it observes *"the domestic market in small advanced economies is too small to get the required levels of scale and specialisation."*[65]
m. So the report helps us understand how being in the UK allows Scotland to enjoy the benefits of a shared currency and large domestic market, how it allows Scotland to avoid the fiscal constraints that would inevitably apply were Scotland a stand-alone economy and how, by implication, Scotland within the UK benefits from levels of public spending that would otherwise be unsustainable.
n. Being in the UK offers fiscal strategy options that independence precludes. The UK (with its own stable currency and a deficit forecast of just 0.7% by 2021/22) has capacity for fiscal stimulus that the report shows us an independent Scotland simply would not have. The Commission's findings demonstrate that those who oppose austerity cannot logically favour independence unless they are prepared to sacrifice fiscal credibility.
o. Faced with this evidence of the benefits of Scotland remaining in the UK, we find ourselves asking what the economic benefits of independence are that makes the Commission so convinced that independence is 'the answer'.
p. The evidence that Scotland would somehow achieve greater economic growth just by dint of becoming a small advanced economy is tenuous at best – particularly as the necessity to reduce public spending would be likely to harm growth, not improve it.
q. The report talks a great deal about the downsides of Brexit, but it is far from clear that an independent Scotland would be able to rejoin the EU

[62] *"Given the nature of Scotland's economy, society and geography there is no doubt that the challenges facing the country are distinct from many parts of the rest of the UK." [B1.17]; "At the same time the delivery of public services can be more expensive than in smaller urbanised geographies." [B1.18]*
[63] The 2013-14 GERS report observed *"lower population density in Scotland relative to the UK [...] increases the cost of providing the same level of public service activity, particularly in areas such as education, health and transport"* http://www.gov.scot/Publications/2015/03/1422/8
[64] The Scottish population is 8.3% of the UK's population, so 91.7% if we're being picky
[65] A3.8

(particularly given the currency issue) and the report does not test whether the ideas they suggest for economic growth would be possible as an EU member state.

r. The report reluctantly concedes that *"While this report considers the public finances of an independent Scotland, it is not inconceivable that many of the positive recommendations detailed here could be implemented in advance of such a move."*[66] The words 'in advance of' could easily be replaced with 'instead of', which strikes us as a rather enticing option.

In the spirit of seeking to contribute to a positive ongoing debate about how best to grow Scotland's economy, we would suggest the following as broad questions worthy of further research and discussion:

- Which of the report's recommendations can be taken forward with existing devolved powers?
- What changes to devolved powers would be required to progress other recommendations (migration being the obvious example)?
- Related to the above, if we don't presume independence as the answer, what can we usefully learn from other international regional, provincial and state devolution models?

In addition to these broad questions, we suggest the following specific issues warrant further investigation

- Is Scotland's higher per capita spending (see Figure 8) fully justified by structural reasons, or are there opportunities to reduce spending in certain areas to free capacity for growth-driving investment elsewhere?
- One of the main contributors of research to the Commission has published some of the background research which the Commission were unable to find room for. This includes the observation that *"Scotland's PISA scores in maths, reading and science are towards the bottom of the advanced economy rankings".*[67] Given the importance of education in driving long-term economic success, we would welcome more debate around why Scotland's fully devolved education system appears to be lagging international benchmarks.[68]
- The report makes non-specific reference to the need for greater infrastructure investment – we would welcome the development of specific proposals with robustly evaluated business cases.

[66] B1.22

[67] "Policy insights for Scotland from small advanced economies" - https://reformscotland.com/wp-content/uploads/2018/06/Policy-insights-for-scotland-from-small-advanced-economies.pdf

[68] Including what practical steps could be taken to improve language skills, something the report highlights as an important factor in developing export growth: *"An export-based growth strategy will therefore require that skills gaps in sales and languages are addressed."* [A6.85]

- We were disappointed not to see more specific industrial policy recommendations. The report states *“One near-term priority should be to identify the existing strengths and capabilities in the Scottish economy and assess how to support their growth, across all policy areas. These could include the energy sector (including renewables), food and drink, tourism, financial services, science and innovation, digital industries, biotech, education and so on, which are already the focus of economic development policy in Scotland.”*[69] We agree.

We see in the Growth Commission report the kernel of a more attractive strategy than assuming separation from the UK is necessary to improve Scotland’s economic growth.

The report in fact illustrates many of the downsides of independence while highlighting (albeit reluctantly) the economic benefits of our inevitably flawed but enduring 300 year-old union. An approach which seeks to grow Scotland’s economy by constructively building on the strengths of this union would seem to us favourable to one that seeks to destroy it.

Using the devolved powers Scotland already has (or may develop) to pursue the Commission’s growth ideas without creating the unnecessary disruption, uncertainty and further austerity that separation from the UK would entail would be a logical and constructive way of taking forward the Commission’s work.

[69] A3.50

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1. Smaller isn't Necessarily Better

The report does not make a case for small advanced economies being intrinsically superior to larger ones.

The report's basic thesis is that an independent Scotland would be a "Small Advanced Economy" (SAE) and that we should therefore judge Scotland's potential, and seek to identify best-practice to replicate, by studying a *"peer group of the 12 most successful small advanced economies".*[70] This is an eminently sensible approach when it comes to seeking best-practice to replicate.

However, a word of caution is needed. Although the criteria used for selecting the peer group (the 'cohort') are not explicitly given, the wording above makes clear this cohort is pre-screened for success. This point is very simply illustrated by figure 1, which draws on the same data sources the Growth Commission uses.

Figure 1

IMF Advanced Economies

All >2m and <25m population

	Population		GDP/Capita	
	2016 (m)	vs Scotland	2016 $US	vs Scotland
Latvia	2.0	0.4	14,009	0.3
Slovenia	2.1	0.4	21,668	0.5
Lithuania	2.9	0.5	14,919	0.4
Puerto Rico	3.4	0.6	30,790	0.8
Ireland	4.7	0.9	64,793	1.6
New Zealand	4.7	0.9	39,050	1.0
Norway	5.3	1.0	70,652	1.8
Scotland	**5.4**	**1.0**	**40,127**	**1.0**
Slovak Republic	5.4	1.0	16,550	0.4
Finland	5.5	1.0	43,514	1.1
Singapore	5.6	1.0	55,241	1.4
Denmark	5.7	1.1	53,774	1.3
Hong Kong SAR	7.4	1.4	43,497	1.1
Switzerland	8.3	1.5	80,311	2.0
Israel	8.5	1.6	37,192	0.9
Austria	8.7	1.6	44,733	1.1
Sweden	10.0	1.8	51,471	1.3
Portugal	10.3	1.9	19,880	0.5
Czech Republic	10.6	2.0	18,506	0.5
Greece	10.8	2.0	17,876	0.4
Belgium	11.3	2.1	41,388	1.0
Netherlands	17.0	3.2	45,658	1.1
Taiwan Province of Chi	23.5	4.4	22,541	0.6

Source: IMF and Scottish Government GERS

Included in Growth Commission SAE peer group

[70] 3.1 (p.12)

This table only shows all ‘advanced economies’[71] with populations greater than 2m and less than 25m. Looking at the final column, it’s obvious that all countries with a materially lower GDP/Capita than Scotland have simply been excluded from the Growth Commission’s SAE ‘peer group’.

We shouldn’t be surprised, therefore, when the report later observes *“there is a gap between Scotland’s economic performance and that of other small advanced economies”*[72] given that the evidence offered is a GDP/capita comparison with this ‘peer group’. Understanding how this group has been selected, any other finding would have been inconceivable.

The report claims that *“In a similar way, a benchmark group of 10 large advanced economies is constructed”.*[73] This is misleading. In contrast to the SAE group where a number of underperforming countries were excluded, the LAE group contains *all* of the 10 largest advanced economies, including low GDP/Capita countries like Spain, Italy and Korea (as well as low growth countries like Italy and Japan). The only country excluded that satisfies the Growth Commission’s stated criteria[74] for LAEs is Taiwan, a country with particularly high historic GDP growth.[75]

Perhaps the clearest illustration of the bias in the construction of the cohorts is that Spain is included in the LAE group, but Portugal is excluded from the SAE group (without explanation).

In the Summary the report asserts *“Small economies perform better than larger ones consistently by around 0.7 percentage points per year over the last 25 years on average.”*[76] This statement is simply wrong. It is just one of several examples[77] where the report casually refers to ‘small advanced economies’ rather than ‘our selected group of better performing small advanced economies’.

This is not a trivial point: readers are given the clear impression that conclusions are being drawn about *all* small advanced economies, whereas in fact they are observations about this specially selected cohort only.

Even when data is not involved, the Commission appears only able to see the positive arguments for being a small country. They state *“small countries have benefited from a relatively benign global political environment in which being small does not create major*

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[71] as defined by the IMF http://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

[72] A1.31

[73] A1.86

[74] IMF defined ‘advanced economies’ with populations over 20 million people [A1.86]

[75] Over the GC’s chosen 25 year period, Taiwan enjoyed 4.6% pa growth compared to the SAE cohort’s average growth of 2.8%

[76] 3.17

[77] There are too many examples to list here: the report adopts the terms ‘small advanced economies’ as a misleading shorthand for the ’12 chosen SAEs’

security risks".[78] One doesn't need to be an inveterate pessimist to observe that – in a world of Trump, Putin and Kim Jong-un – it would be naive to rely on a 'relatively benign global political environment' persisting.

The Commission does concede that small economies' *"GDP growth trajectory tends to be more variable. A lesson therefore is to be aware of exposure to externally sourced volatility and plan accordingly."*[79] Unfortunately the report does not address the question of how to 'plan accordingly', and no analysis is offered to show how sensitive their proposed economic model is to different growth outcomes.

The Commission's determination to only seek positives and to ignore the negatives of being a small advanced economy is perhaps best illustrated by the fact that, in over 119,000 words of text, Greece is not mentioned once.[80] This omission is particularly disappointing because lessons can be learned from others' failures as much as they can from others' successes. The hazards of using a currency over which one has little or no monetary control is but one obvious example.

The report does not tell us how 'small advanced economies' perform generally, it tells us how well *some* successful small advanced economies have performed.

[78] A2.19
[79] A2.13
[80] Greece appears in two charts only; Slovak Republic, Israel, Portugal and Czech Republic are only mentioned in passing

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2. Stretching the Empirical Data

The 'growth potential' claims made are unrealistic.

The Growth Commission report is 354 pages long. The Summary takes up 41 pages and contains 224 distinct clauses (one alone of which contains 30 sub-clauses). It's fair to say this report is not designed to be an easy read and that only the most committed drudges (like this author) will actually read it all.

Given this, it is informative to see how the report has been spun by its authors and sponsors, to see what they have tried to get people to take away from it. We can then see whether the report backs up the claims made on its behalf.

Ahead of the report's publication a press release[81] was issued which previewed the report's "*core finding*" that *"an independent Scotland can emulate the world's 12 best performing small advanced economies (SAEs), closing the growth gap and driving GDP per head to the median of these best performing countries".*

In fact the report observes how those countries perform and asserts that Scotland should aspire to these targets – that's not the same as showing that Scotland *can* emulate these countries. There is nothing wrong with a statement of ambition, but it should be recognised as such and not as something more.

More importantly, we should focus on the quantitative claims made in the press release because these are claims on which the entire economic case (insofar as one exists) is founded:

> <u>Claim 1:</u> *"The report concludes that achieving this would be worth an additional economic output in Scotland equivalent to an extra **£4,100 per person** in Scotland."*
>
> <u>Claim 2:</u> *"The analysis shows that small economies have performed better than larger ones consistently by around **0.7 percentage points per year** in economic growth rate, over the last 25 years on average."*

It is worth noting that both of these figures are based entirely on observations about the aggregate performance of economies in the carefully selected cohort already discussed (so the use of the phrase 'small advanced economies' is misleading). There is no direct link at all between either of these figures and the actual policy recommendations made in the report – yet these figures are used not just to scale the aspirational goal but, later in the report, are also implicitly used to scope how long it might take to reach it.

Taking the first claim, this is merely a corollary of saying "if Scotland's GDP/capita was the same as the Netherlands, we'd have £4,100 more GDP/capita". It's an observation

[81] https://www.sustainablegrowthcommission.scot/latest/

that, while unimpeachable as a statement of the obvious, leaves something to be desired in terms of insight.

The analysis is no more sophisticated than ordering the 12 ‘peer group’ countries in order of descending GDP/Capita and comparing Scotland’s GDP/capita to that of the country in the middle (i.e. the ‘median’ country, in this case the Netherlands). Given that the peer group excludes countries with materially lower GDP/Capita than Scotland[82], it’s inevitable that Scotland sits below the median point. The arbitrary nature of this comparison cannot be stressed enough. We could argue for different cohort structures and end up with different median countries and therefore different headline “achieving this would be worth” figures, but this would be merely to indulge in statistical gerrymandering of our own.

The Growth Commission looks at the GDP/capita of the Netherlands and asserts *“This provides a measure of what Scotland can achieve in the future if it has the same ability to tailor economic policy to its own needs and advantages as these other countries do.”*[83] There is an implied causal link between the observed GDP/Capita difference and ‘having the same ability to tailor economic policy’ – but at no point does the report actually make a case for this being the main, let alone the sole, explanatory variable. Factors such as membership of a particular trading bloc (or not), natural resources, climate, geographic proximity to other markets, language, population density, political stability, cultural work-ethic and many others may be better explainers of GDP/Capita differences than just ‘being independent’.

Similar problems exist with the second claim, which is based on the mean average real GDP growth rates of the ‘peer group’ versus the larger advanced economies. The Large Advanced Economy (LAE) cohort has not been pre-selected for success, so immediately we can see that this isn’t a like-for-like comparison. There are any number of ways we could argue to re-cut these comparisons, all of which lead to a lower observed GDP growth gap over the last 25 years.

- Using the Growth Commissions definition of successful SAEs and comparing to their defined LAEs we get their growth rate difference figure of +**0.65%**[84]
- If we apply the less biased (although still questionable) criteria of comparing all SAE’s with population greater than 3m but less than 10m against all LAEs with populations greater than 20m we get a growth rate difference figure of +**0.31%.** This change alone more than halves the apparent growth difference and therefore more than doubles any timeframes which rely on this assumption.

[82] New Zealand is the only country included with a lower GDP/Capita than Scotland, its GDP/capita being 2.7% lower – advanced economies excluded without explanation are: Slovak Republic, Israel, Portugal, Czech Republic, Greece
[83] A1.32
[84] It’s a trivial point, but the GC has rounded this figure up to 0.7%

- Alternatively, given that the report asserts Scotland's *"aspiration for EU membership"*[85] and that this would be likely to involve adopting the Euro[86], we can look at the performance of 'Eurozone SAEs' against the LAEs[87]. This shows a growth rate difference figure of **+0.26%** over the last 25 years (dropping to just **+0.07%** since 1990). This comparison is particularly relevant because being an EU member states places constraints on the economic strategies a country can pursue (state-aid restrictions and requirements to adhere to EU trade agreements being two obvious examples).
- Following the logic of the report's *actual recommendations*, we could take the GC's SAE cohort and simply exclude Singapore, Hong Kong, and Ireland[88], because the Growth Commission explicitly rejects their low tax[89] models.[90] Just taking these three countries out of the SAE cohort actually reverses the growth gap, with this adjusted SAE cohort in fact growing slightly **more slowly** than the LAEs, a difference of **-0.11%.**
- As a last test, we can look only at the performance of those SAEs that the Growth Commission goes on to suggest Scotland should most seek to emulate (Denmark, Finland and New Zealand)[91]. The average growth rate of these countries compared to the LAEs is immaterially different at just **+0.06%.**
- The report itself even observes that *"several small Northern European economies have generated sluggish growth performance since 2000 (notably Denmark, Finland, and the Netherlands)".*[92] This is undeniably true as all of these countries have in fact seen slower growth than the UK since 2000.[93]

All of this shows us that the '+0.7% superior growth' figure which emerges as a headline from the report is not a robust assessment of how small advanced economies *in general* fare against large ones.

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[85] B8.63

[86] The report is equivocal about this, stating *"Scotland would join the euro only if and when such a decision is in the best interests of both Scotland and the EU, and the relevant criteria of the Maastricht Treaty were met"* [C4.15] – but given the currency challenges an independent Scotland would face and the EU's stated criteria for new member states, this seems at the very least a realistic long-term scenario (if economic conditions could be met) *https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/who-can-join-and-when_en*

[87] We have stayed with the Growth Commission's definition of LAE's here, so high growth Taiwan is excluded (thereby favouring SAE's in any comparison)

[88] There is also an issue with Ireland's GDP having an unusually high share of overseas ownership (largely because of the low tax model). GNI would arguable be a better measure, but unfortunately the IMF does not record this figure. See https://www.ft.com/content/dd3a6f1c-6aea-11e7-bfeb-33fe0c5b7eaa

[89] "*not competing as a low tax location"* [3.58, p24, p44, A3.100, p154]; *"unlikely that [Scotland] can successfully operate an Ireland/Singapore model*" [A3.77]; "*little sense in competing as a low cost or low tax location"* [A3.82]

[90] The Growth Commission also rejects the Singapore and Hong Kong models based on their high income inequality outcomes [Figure 2-9]

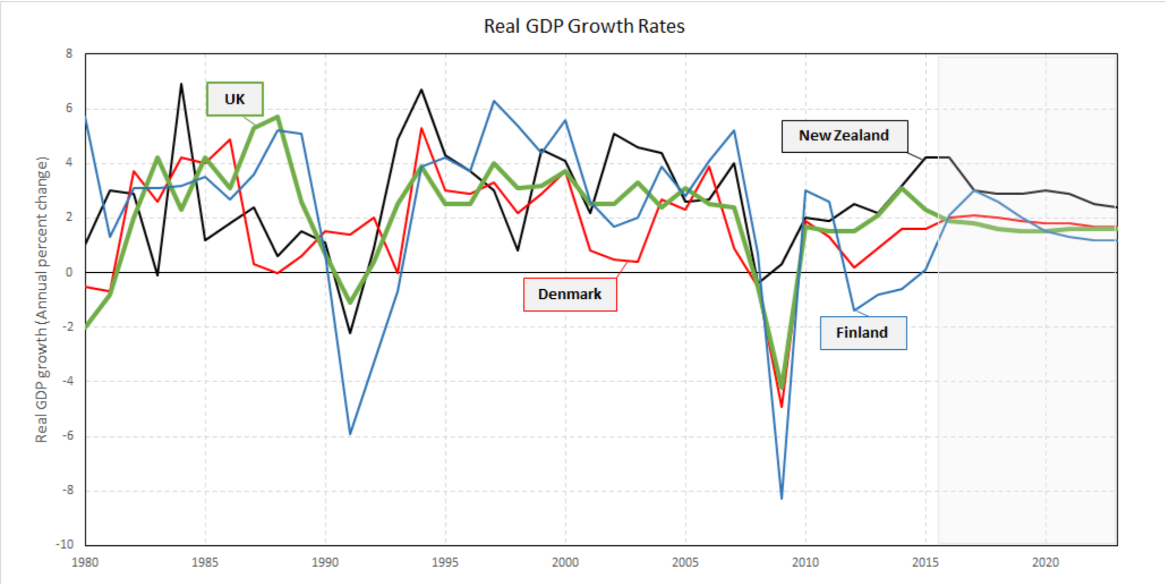
[91] "we are especially drawn to a hybrid of Denmark, Finland and New Zealand" [3.58]

[92] A2.6

[93] Source IMF: UK = 1.87%, Den = 1.14%, Fin = 1.49%, NL = 1.39%

In fact, there is no empirical evidence to suggest that following the models of those economies the Growth Commission most seeks to emulate will deliver greater GDP growth than Scotland could expect to achieve while remaining within the UK. This point is clearly shown by Figure 2.

Figure 2



Source: IMF, These Islands

As well as illustrating the greater growth volatility experienced by SAEs, this graph also shows that New Zealand is the only one of the 'chosen three' which shows reasonably consistently superior GDP growth to the UK. But focusing on GDP growth alone masks an important issue which the report itself highlights: *"New Zealand's migration-driven growth model [means that] despite GDP growth of 3.6%, per capita income growth has been around 0.6%."*[94] Give the Commission recommends migration-driven growth, this is a topic we'll return to.

In the context of the actual policy recommendations the Growth Commission goes on to make, the +0.7% figure is frankly irrelevant. There can be no justification for using this figure when assessing the likely impact of the report's actual recommendations.

In no way does this negate the value of seeking to learn from others' success – but to have a constructive and honest debate we must be realistic when assessing the medium-term potential upside for Scotland's stand-alone economy.

[94] A1.92; according to IMF data, New Zealand's 2000 – 2016 population growth was 1.28% pa compared to the UK's 0.68%

3. Failing to Make a Case

The report does not make a case for independence.

The Commission's formal 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 …"*[95]

The Commission's members appear to have interpreted 'under different potential governance scenarios' to exclude any governance scenarios that don't assume independence. This is perhaps understandable give that the political party sponsoring the Commission and the Commission's Chair are openly committed to independence as the only acceptable outcome.

Unfortunately, this presumption is just one of the reasons why the report inevitably (to quote John Kay, a member of the First Minister's standing council on Scotland and Europe) *"falls short of presenting an economic case for independence".*[96] The Commission makes no attempt to compare independence with any alternative scenarios that would involve Scotland remaining part of the UK.

This is particularly frustrating given that the report is unequivocal when it states that *"Scotland is without question a rich and successful nation, in the top 25 of global economies in terms of income per head and ranks near the top in the UK on most long-term indicators."*[97], celebrates the fact that *"Scotland's economic performance is, like the UK, amongst the best performing decile in the world economy"*[98] and makes the explicit observation that *"many of our recommendations could be agreed and implemented [...] with existing or enhanced policy responsibilities for Scotland's Parliament & Government".*[99]

Insofar as the report attempts to make an economic case (a question we will return to), it falls short primarily because it doesn't compare independence against the alternative of seeking to implement the commission's policy ideas using the devolved powers the Scottish Government already has (or may be able to gain).

It is self-evidently the case that, given many of the report's recommendations could be implemented with existing or enhanced powers, it is wrong to attribute all of the upside the report claims to the act of Scotland becoming independent. This issue is exacerbated by the fact that the downsides considered by the report (e.g. currency, transition costs, need for greater fiscal prudence) as well as those the report ignores

[95] 1.2 (p.1)
[96] FT (01/06/2018) https://www.ft.com/content/f38ec3e4-64ef-11e8-bdd1-cc0534df682c
[97] 3.19
[98] A1.33
[99] 2.19 – the words omitted are 'in advance of independence' as that is to unnecessarily presuppose independence as the inevitable conclusion

(e.g. trade friction with the UK, economic shock of separation) are exclusively associated with independence.

The report also fails to address whether any of the reasons why Scotland is a 'rich and successful nation' might be attributable to its 300+ year membership of the United Kingdom.

Large parts of the report, whether dealing with the need for tighter fiscal discipline or trying to resolve the currency issue, are spent addressing problems that only exist if we presuppose independence as the answer.

Frequent reference is made throughout the report to the importance of "*Securing frictionless borders with the rest of the UK and EU*".[100] Scotland already enjoys frictionless borders with the rest of the UK – indeed they are explicitly provided for in the Act of Union[101] – and only independence would jeopardise this.

If Brexit does lead to trade friction between the UK and the EU, when facing the question of prospective independence it seems likely that Scots would be faced with a choice between frictionless access to the UK *or* the EU.[102] Given that Scotland trades 3.6 times more with the rest of the UK than we do with the EU[103], the frictionless borders imperative would clearly favour Scotland remaining in the UK.[104]

The report makes the observation that *"leaving the EU and Single Market would obviously act as a growth restraint for Scotland".*[105] Give the UK single market is so much more important to Scotland than the EU, it follows that leaving the UK and the UK single market would 'obviously' act as an *even greater* growth restraint for Scotland. The Commission cannot have been unaware of this, so their failure to address and quantify this issue is a telling omission: the equivalent in the Sherlock Holmes story of the dog that did not bark in the night.

Unlike Scotland's trade with the EU, Scotland's trade with the rest of the UK (rUK) is in part supported by the fact that we share a currency. Given the Growth Commission's recommendation that Scotland should *"move to an independent Scottish currency at*

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[100] 3.98, recommendation 6, and several other locations (in slightly different wordings): p22 (3.88), p25 (point 6), p107, p119 (A6.40), p123 (A6.63), p150 (A6.210), p155 (point 6)

[101] The Act of Union explicitly provides for "*full freedom and intercourse of trade and navigation*" and "*the same customs and duties on import and export*", that *"laws concerning regulation of trade, customs and such excises [...] be the sam*e" and "*the coin shall be of the same standard and value throughout the United Kingdom*" http://www.legislation.gov.uk/aosp/1707/7/introduction

[102] The report simply asserts *"It is wrong to suggest that Scotland would have to choose between the two markets." [A6.69]*, but does not attempt to justify this assertion

[103] Source: Export Statistics Scotland 2016
http://www.gov.scot/Topics/Statistics/Browse/Economy/Exports/ESSPublication

[104] As the report observes: *"The high proportion of Scottish exports going to the rest of the UK (61%, excluding oil and gas) should not be surprising since countries typically trade far more with near neighbours who share the same language, land border, single market and have longstanding economic ties". [A6.42]*

[105] 3.45

such time as this was considered appropriate for the Scottish economy"[106] it is clear that there would be additional 'economic shock' risks for Scotland/rUK trade which don't apply in the case of Brexit. We'll come on to discuss the potential impact for the financial services sector, but this issue is far broader than that. Companies serving the whole UK market from facilities in Scotland would need to consider the risk of future foreign-exchange exposure and currency-related trade friction when making their long-term investment decisions.

The report makes multiple references to the "*forthcoming economic shock from Brexit"*[107] and cites work from the Fraser of Allander Institute which suggests between 30,000 and 80,000 Scottish jobs may be at risk because of this.[108]

Fraser of Allander produced a report[109] in April 2017 which showed that, while 125,000 Scottish jobs were supported by rEU exports, 529,000 Scottish jobs were supported by rUK exports. By considering the risks Brexit poses to the 125,000 without making any reference to the risks Scotland leaving the UK would pose to the 529,000, the report fails to meet the Chair's stated aspiration to paint a picture of hope that is *"grounded in clear-sighted reality and a rigorous plan."*[110]

A plan that simply ignores the downsides of its proposals cannot be considered to be either clear-sighted or rigorous.

An economic case for independence that ignores the fact that many of the benefits it includes do not require independence to achieve them is no economic case at all.

[106] 3.204
[107] A1.29 and several other locations (in slightly different wordings): p10 (A1.29), p11 (A1.36), p20 (A1.72)
[108] 3.35
[109] https://www.sbs.strath.ac.uk/economics/fraser/20170420/Exports-and-Employment-Scotland.pdf
[110] 2.7 (p.6)

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4. A Reality Check

Far from being more realistic, the report is objectively more optimistic than the 2014 White Paper.

Some have reacted to the publication of the Growth Commission's report by praising its realism compared to the 2014 independence White Paper. We challenge this assessment because, having interrogated the assumptions used, we find that the report is in fact objectively more optimistic.

The Independence White Paper assumed net savings versus the GERS figures of £600m[111], but the Growth Commission assumes net savings of £2,600m.[112] We do not need to go into the detail to see that this is objectively a more optimistic assumption, but we can make the following observations as to why this greater optimism appears misplaced (and the supporting analysis is fundamentally flawed).

The largest claimed saving is for spending reductions compared to allocated UK government spending of 0.8% of GDP.[113] The justification for this figure in the report is unclear and based on demonstrably flawed assumptions.

- The report suggests a comprehensive 2 year review to analyse *"where savings could be made where costs need not be replicated"* [B4.57]. The report then [B4.58] seems to declare the result of this proposed analysis by stating *"This analysis shows an improvement in the public finances of around £1 billion [...] the equivalent of 0.8% of GDP".*
- An immediate concern here is that £1 billion is in fact 0.63% of 2016-17 GDP[114], but inexplicably the figure of 0.8% is the one the report goes on to use.
- An even bigger issue is the way in which the £1 billion figure is justified. It is explained[115] as being made up of savings of £0.4bn and revenue benefits of £0.6bn.
- The asserted potential saving of £0.4bn from costs *"that will no longer be required"* is supported by a few examples that total just £170m[116] and which

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[111] "*We expect these changes to deliver savings or increases in revenue totalling around £600 million in a full year.*" – Scotland's Future, p.78

[112] The figures used in the report are presented inconsistently (sometime as percentage of GDP, sometimes in 2015-16 terms, sometimes in 2021/22 terms). Taking the 'lower spending as percentage of GDP' claims made under B4.67 and applying them to 2016-17 GDP we get: Defence (0.4% of GDP) = £0.64bn; Debt Servicing (0.4% of GDP)= £0.64bn; savings from allocated UK government spending (0.8% of GDP) = £1.28bn. This totals £2.56bn.

[113] B4.67

[114] Using 2016-17 GERS figures, 1bn is 0.63% of the £159,389m total GDP figure (or 0.67% of the £150,025m onshore GDP figure). The later modelling appears to take the 0.8% saving as being applied to total GDP, but this assumption is not made explicit – either way, 0.8% is too high.

[115] B4.58

[116] B4.58: £50m associated with running costs of the House of Commons & House of Lords, £20m for the Scotland Office and "*more than £100m for Whitehall Department running costs*"

include a sweeping "*more than £100m for Whitehall running costs that will not need to be duplicated in Scotland".*[117]

- The revenue benefit of £0.6bn is explained as being associated with £2.4bn of "*spending that is allocated to Scotland but takes place elsewhere".*[118] Not only does this £2.4bn include costs that the report has just assumed will be saved (and so can't be transferred), the assertion that all of this £2.4bn[119] of spending currently allocated to Scotland takes place outside of Scotland is simply wrong.
- To illustrate with just one cost area: the £2.4bn includes £484m[120] of 'Public & Common Services' costs. In 2015-16 the equivalent figure was £467m, a figure we can break down in detail by using the GERS expenditure database.[121] This shows us that not only does this figure include all of the costs that the Growth Commission has explicitly assumed will be saved[122], but that it includes spend which already takes place in Scotland. The figure includes, for example, £234m[123] of current expenditure on HM Revenue & Customs, this being Scotland's 8.3% population share of the total UK figure.[124] In fact we know that 12% of HMRC headcount is currently based in Scotland[125], so it is simply wrong to assume that Scotland would benefit from transferring this expenditure to Scotland. In fact, in this specific example it seems likely that Scotland would see economic harm as a result of independence, as a greater share of HMRC employees are in Scotland than Scotland's population share.[126]

So the first assumed saving of 0.8% of GDP from spending reductions (compared to GERS allocated UK government spending) falls apart when tested and is clearly heavily overstated.

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117 According to the 2015-16 GERS expenditure database, a total of just £36m is allocated to Scotland for House of Commons and House of Lords; the Scotland Office figure is £23m; IPSA is £17m (which we presume in included in the Commission's 'House of Commons & House of Lords' total).
118 B4.58
119 This figure appears to be made up of total allocated spending (Table 4-2) of £4.7bn less international affairs (£0.8), all economic affairs (£1.0bn), and we presume accounting adjustments and EU transactions (£0.5m)
120 Table 4-2
121 http://www.gov.scot/Topics/Statistics/Browse/Economy/GERS/GERS2017xls
122 House of Lords & House of Commons (£36m), Scotland Office (£23m) and various "*Whitehall Costs*" including Cabinet Office, DfID, HMRC, HMT etc.
123 This £234m is categorised as 'non-identifiable expenditure' in the database, but this does not mean the expenditure takes place outside Scotland. We suspect this may have been the cause of the Commission's misunderstanding.
124 £2,838m, defined in the GERS expenditure database as: HMR041-S041A003-UK-TES_CUR-Non-ID-CG-SUB010100
125 Institute for Government, "Governing after the Referendum" - Figure 2, page 24: https://www.instituteforgovernment.org.uk/sites/default/files/publications/Scenarios%20paper%20-%20final%20APJR.pdf
126 Of course to answer this question properly we'd need to know the share of spend, not just share of employment – but the point at issue here is that the Growth Commission's assumptions are clearly incorrect.

The report goes on to assume a *further* 0.3% of GDP (c£0.5bn) will be saved from "*creating best in class institutions*".[127] The possibility that the loss of shared scale may in fact lead to relatively higher costs is not considered.

The second element of assumed saving is 0.4% of GDP from *"lower debt servicing costs when a share of net assets is taken into account"*.[128] This assumes a negotiated settlement with the UK government which would seem remarkably favourable to Scotland. The analysis relies on "netting off" the difference between Scotland's population share of UK assets and those actually "held" by Scottish Government and Local Government according to CIPFA.[129] This paper does not attempt to validate this assumption, but we observe that it assumes a favourable outcome of an uncertain and complex negotiation.

The final element of assumed saving is 0.4% of GDP on defence. This compares with a saving of 0.49% of GDP assumed in the 2014 independence White Paper.[130]

The aggregate of the above shows that the Growth Commission has been, net, about £2bn pa more optimistic than the White Paper when it comes to 'day 1' cost-savings and that this greater optimism is not justified. £2bn is equivalent to 1.2% of 2016/17 GDP. Reversing this unjustified increase in optimism would move the 'legacy deficit' up from 5.9% to 7.1%, which in turn would increase the amount by which spending growth would need to lag GDP growth to satisfy the Commission's first fiscal rule.[131]

It is worth noting that the Commission assumes all of these speculative savings would be used to reduce the deficit rather than to fund any increase in public spending in other areas.

The assumption made by the growth commission that independence could deliver long term +0.7% p.a. higher GDP growth contrasts with the observation made in the White Paper that between 1997 and 2007 "*small countries used for comparison*" demonstrated a real GDP per capita growth gap of +0.12% p.a. (compared to Scotland's onshore GDP per capita growth[132]).

This highlights both the greater optimism of the Growth Commission's assumptions[133] and the problem with the Commission's focus on GDP growth rates rather than the far

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[127] B4.59
[128] B4.67
[129] B3.18, B3.19
[130] ***Scotland's Future***, p237: *"maintaining the commitment to a budget for defence and security in an independent Scotland of £2.5 billion"*; White Paper figures were based on 2011/12 GERS which included £3,236m for defence, implying a saving of £736m or 0.49% of 2011/12 GDP
[131] Our model suggests this change in assumed starting conditions would mean spending growth would have to lag GDP growth by 1.5% to meet the Commission's first Fiscal Rule of getting the deficit below 3% within a decade
[132] ***Scotland's Future***, p.619, note 59.
[133] For a 0.7% pa GDP growth rate assumption to be less optimistic than a 0.12% pa GDP per capita growth rate assumption, we'd need to assume population growth of 0.58% pa. This compares with a current OBR forecast of 0.27% pa growth (for Scotland's over 16 population).

more useful GDP/Capita growth rate as a measure of economic success.[134] This is particularly relevant given that the Commission's failure to quantify its population growth goals makes the GDP/capita outcome unquantifiable.

The Commission assumes that Scotland would face *"total transition-period costs of around £450 million in the two years leading up to independence and the first three years immediately afterwards"*.[135] This is based on work carried out by Professor Patrick Dunleavy of the London School of Economics.

During the independence referendum Professor Dunleavy was quoted as saying the 'immediate set-up costs' for an independent Scotland would be £200m. When robustly challenged on this assertion by Professor Iain McLean of Oxford University (who suggested the correct answer was "probably closer to £2bn than £1bn"[136]) he responded by suggesting that "the total transition costs over a decade" would lie in a range of £0.6bn to £1.5bn.[137]

In early 2017, Nicola Sturgeon wrote to then Prime Minister David Cameron explaining that the "set up costs" just for the limited Welfare powers being devolved as a result of the Smith Commission proposals would be "between £400m and £660m".[138]

Audit Scotland have reported that the IT project for rural payments cost £178m. [139]

In this context, the assumption of "*around £450m*" as a total transition cost figure for an independent Scotland is simply not credible.

If independence were economically justifiable, transition costs of even £2bn would not make a material difference to the economic case – so we find it strange that the Commission have chosen to 'low-ball' this figure so blatantly.

The report claims that the 5.5% 'legacy deficit' they project has been arrived at using *"very conservative assumptions"*.[140] Based on the observations above, we do not see how that statement can possibly be justified.

It is fair to note that exclusion of oil revenues from the calculations *is* an explicitly conservative assumption. But given Scotland's oil revenues have totalled just £264m[141]

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[134] As the report observes: *"Population trends can be an indicator of economic health, but GDP per capita is a more useful measure of economic performance"* [A1.19]; *"The overall level of GDP in a country is less important to individuals than the level of GDP per capita."* [A1.41]
[135] B5.17
[136] http://blogs.lse.ac.uk/politicsandpolicy/what-will-it-really-cost-to-set-up-an-independent-scotland-a-critique-of-patrick-dunleavys-report/
[137] http://blogs.lse.ac.uk/politicsandpolicy/a-debate-about-scotlands-transition-costs-a-response-to-mcleans-critique/
[138] https://firstminister.gov.scot/letter-to-the-prime-minister/
[139] http://www.audit-scotland.gov.uk/news/it-project-for-rural-payments-ends-but-significant-issues-remain
[140] 3.144
[141] GERS 2016-17

over the last 2 years, the conservatism around oil revenues cannot be considered to offset the optimism we have detailed above.

The Commission largely avoids discussion North Sea oil, although it does make the surprising insinuation that the UK Government was at fault for reducing the tax burden on this ailing sector: *"However, the UK's oil and gas tax receipts have also fallen due to policy decisions taken by the UK Government on the taxation of the sector, for example on tax rates (including setting the rate of petroleum revenue tax at zero in March 2016) and tax allowances associated with investment."* This was an action that the SNP explicitly called for at the time.[142]

By not discussing North Sea oil and gas revenues, the Commission conveniently also avoids considering future decommissioning liabilities, which are estimated at £40bn – £80bn.[143]

Excluding oil revenues from the report appears to have been a symbolic gesture aimed at distancing the Growth Commission from the 2014 White Paper which, famously, forecast £6.8bn – £7.9bn pa of offshore receipts.

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[142] *"The Scottish Government is calling for the headline rate of tax on the industry to be reduced as well as the introduction of an investment allowance and a new tax credit for exploration"* https://www.scotsman.com/news/politics/nicola-sturgeon-calls-for-north-sea-oil-tax-change-1-3691571

[143] http://www.if.org.uk/wp-content/uploads/2018/04/North_Sea_Decomissioning_Press_Release_.pdf

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5. The Truth about Austerity

Claims that the economic model proposed is 'anti-austerity' do not stand up to scrutiny.

There appears to have been a concerted effort on behalf of the report's sponsor and authors to claim that it proposes an economic model that would have avoided the austerity of the last 10 years.

The clearest example of this was a statement made by the report's Chair in an interview with the National newspaper:

> *"If the model we have suggested for reducing the deficit was applied to the last 10 years we would have eliminated the Tory austerity cuts to the Scottish budget."*
> – Andrew Wilson[144]

This echoed similar statements made by First Minister Nicola Sturgeon during FMQs and Growth Commission member Kate Forbes MSP[145] on BBC's Question Time

> *"If the spending recommendations of the Growth Commission had been applied over the past ten years […] it would have eradicated austerity in Scotland. That is the reality"*
> – Nicola Sturgeon[146]

> *" Over the last 10 years the Scottish Budget has been cut by 8.5%; in contrast, this report predicts that if we had been an independent country our spending could have increased by 5% over those 10 years"*
> – Kate Forbes[147]

There are no such claims made in the 354 page report, although the report does assert that *"Scotland should explicitly reject the austerity model pursued by the UK in recent years."*[148]

To test these claims and whether or not the report's assertion is consistent with the report's actual recommendations, we first have to decide what is meant by 'the model we have suggested for reducing the deficit'.

Reading all 224 clauses of the summary, there are only five specific recommendations related to ongoing deficit reduction. Two are unequivocal:

- *3.184: Target a deficit value of below 3 per cent within 5 to 10 years.*

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[144] National, June 2nd 2018 http://www.thenational.scot/news/16265238.Senior_Unionist_figures__privately_admit_the_case_for_independence_is_now_stronger_/
[145] Appointed Public Finances and Digital Economy Minister in the June 2018 reshuffle
[146] FMQs May 31st 2018 https://www.scottishparliament.tv/meeting/first-ministers-questions-may-31-2018
[147] BBC Question Time, May 31st 2018 https://www.bbc.co.uk/iplayer/episode/b0b57r0w/question-time-2018-31052018
[148] 3.162

- *3.185: National debt should not increase beyond 50% of GDP and should stabilise at that level.*

Three are more subjective, confusingly caveated and not necessarily consistent with the first two:

- *3.186: Borrow only for public investment in net terms over the course of the cycle.*
- *3.187: During the transition period real increases in public spending should be limited to sufficiently less than GDP growth over the business cycle to reduce the deficit to below 3% within 5 to 10 years. At trend growth and target inflation rates this would mean average annual cash spending increases of above inflation in contrast to the Scottish budget experience under the UK regime of recent years and that scheduled for the remainder of the current planning period.*
- *3.188: The impact of fiscal management on growth must be tended to and it should be noted that this rule will apply over the business cycle. This means that in periods where growth is expected to be substantially lower than longer-term trend, it will be possible to increase public spending to create the necessary economic stimulus to increase growth.*

Ambiguity is introduced into these summary recommendations by reference to 'the business cycle', a term which is open to interpretation and not defined within the report.

Whatever is meant by 'the business cycle', it's clear it must complete within a 10 year time-period or it wouldn't be possible to comply with the recommendation for increases in public spending to be "*limited to sufficiently less than GDP growth over the business cycle to reduce the deficit to below 3%* ***within 5 to 10 years****.*"[149]

The report itself observes that *none* of the 12 benchmark SAEs run a deficit as high as 3% and in fact most run a surplus.[150] Given that 3% is also defined as the 'excessive deficit threshold' by the EU[151], it seems clear that the Commission concludes that running a deficit of less than 3% is a requirement for fiscal credibility and recognises the need to achieve this within 10 years (although as we'll come on to argue in chapter 6, this does not appear to be a sufficiently aggressive target).

The detail within Part B drives this point home:

> *"... it is important to have a clear, credible fiscal trajectory planned. This should move with pace, aiming to achieve a* ***sustainable fiscal position within 10 years****.* ***This timeline is necessary to ensure consistency with EU fiscal rules****, as well as*

[149] 3.187
[150] B7.12 and Fig 7-1
[151] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/launching-excessive-deficit-procedure_en

> *recognising the limits with financing fiscal deficits of anywhere close to the current level."*[152]

If any doubt remains, the **"Fiscal Rules"** laid out in part B remove it:

> *"From this work, we conclude that the immediate fiscal policy priorities for Scotland will be to agree a binding framework to ensure:*
> - ***The deficit is reduced to below 3 per cent of GDP within 5 to 10 years***
> - *That national debt does not increase beyond 50% of GDP and stabilises. This will automatically constrain what fiscal deficits are allowed*
> - *Borrow for public investment only over the course of the cycle"*[153]

Our interpretation of the report's recommendations is therefore that getting an independent Scotland's deficit below 3% within 10 years[154] would be a non-negotiable priority and constitute their **first Fiscal Rule**. If this is not a non-negotiable priority, then we fail to see how the Commission can credibly claim to be seeking to emulate its chosen 12 successful SAEs (or indeed even begin to build the reserves required for its currency strategy or to prepare to meet the EU's entrance criteria).

In the quote at the beginning of this section, the report's Chair Andrew Wilson referred to "*the model we have suggested for reducing the deficit*" and it seems clear to us that he is referring to the strategy outlined above and specified thus:

> *"**Deficit Reduction Policy:** this should be established with a target of delivering the initial deficit target of under 3 per cent of GDP within 5 to 10 years. **Public spending increases in transition should be limited to sufficiently less than money GDP growth to deliver this**."*[155]

The Policy goes on to state that *"At trend rates of growth and inflation this would allow annual average cash increases of above inflation."* But, as we will demonstrate, only on the basis of assuming GDP growth rates greater than 1.0% pa in real terms *during the initial consolidation period* could the Commission justify their statement that *"For the initial consolidation period, we recommend modest real terms increases in public sector expenditure."* [156]

To be absolutely clear: unless they are prepared to break their own first (and frequently stated[157]) Fiscal Rule, real terms spending increases would only be possible if real GDP

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[152] B8.71, B8.72
[153] Page 93, B12.2
[154] The Commission insists on using the phrase "within 5 to 10 years" - this is clearly intended to mean "within 10 years"
[155] Part B, recommendation no. 42.
[156] B12.16
[157] The first Fiscal Rule as specified here is mentioned more than 10 times within the report

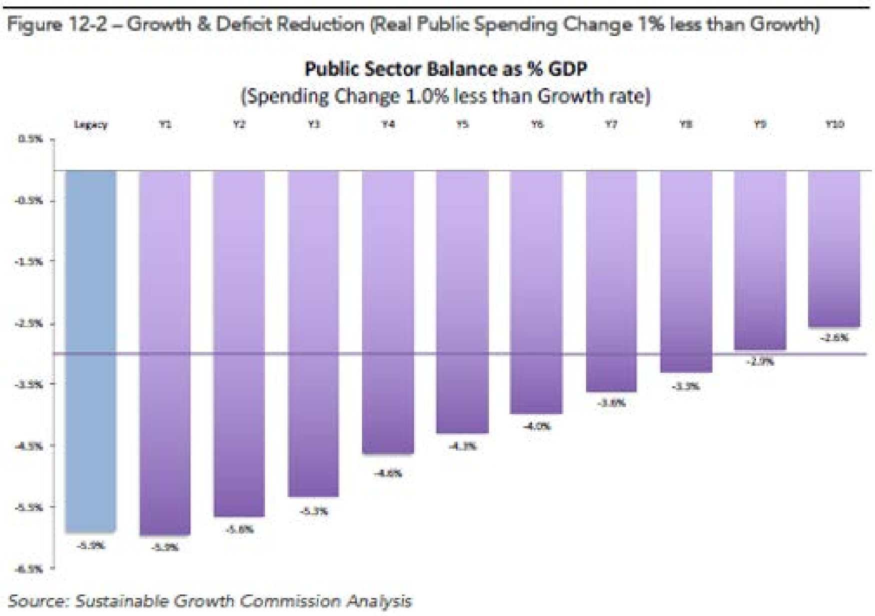
growth rates were sufficiently high to allow this – in their worked example that figure would be need to be above 1.0%.[158]

Having understood what 'the model' is, it is a relatively trivial exercise to show what the implications of applying this model would be under different conditions. Indeed the Growth Commission offers such a model to produce their Fig 12-2 (our Figure 3), where they show the rate at which spending growth would have to lag GDP growth to achieve their 'below 3% within 10 years' first Fiscal Rule.

> *"B12.18: At Scotland's long-term trend GDP growth rate of 1.5%, and inflation at 2%, this would mean that nominal increases in public spending of 2.5% would reduce the inherited deficit from 5.9% of GDP to less than 3.0% of GDP by year 9 (Figure 12-2). Over a ten-year period that would require borrowing that would build up to 36% of GDP, well within the 50% limit of the proposed fiscal framework."*

This illustration makes clear that, using the Commission's optimistically projected "legacy deficit", spending growth would need to be 1% behind GDP growth to satisfy their first Fiscal Rule.

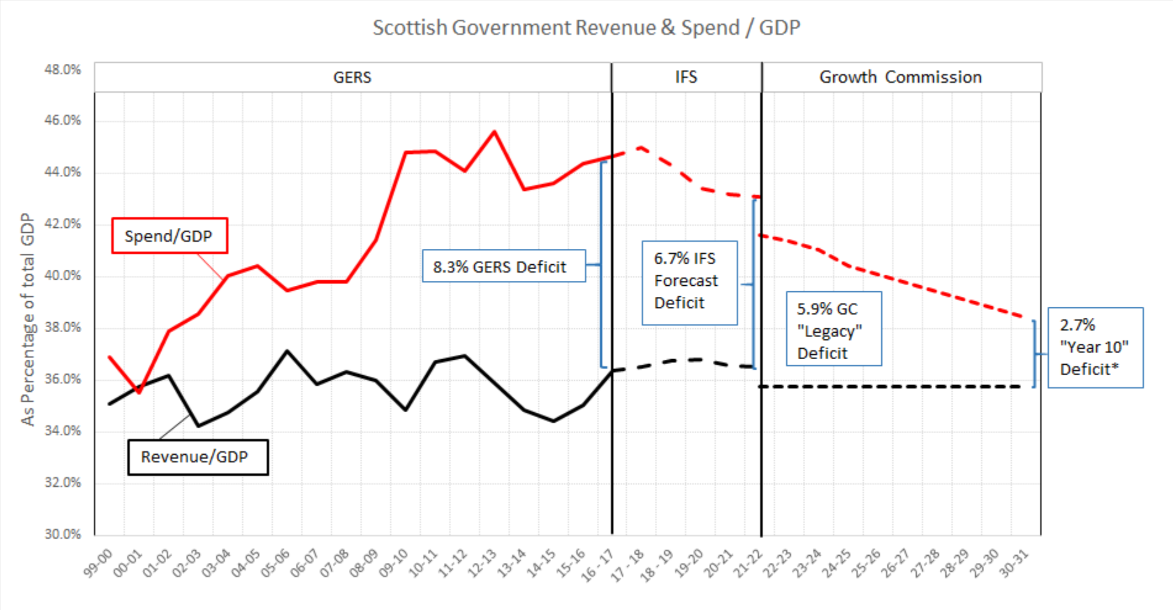
<u>Figure 3</u>



[158] If starting with the deficit position projected for 2020-21 – were the deficit higher, the 1.0% would need to be commensurately higher as well

We have been able to recreate the Growth Commission's model to a reasonable degree of accuracy[159] and this allows us to place the assumed decrease in spend as a percentage of GDP (spend/GDP[160]) in historical context [Figure 4]. [161]

Figure 4



Source: These Islands recreation of Growth Commission figures (using GERS 16-17, OBR Mar 2017 & IFS May 2017)
** Compares with Growth Commission modelled figure of 2.6%*

The graph clearly shows that the implied reduction in spend/GDP is far greater than anything Scotland has recently experienced (or is forecast to experience within the UK).

The report is correct when it states that "*The analysis set out in this report shows that the target of a deficit value of below 3 per cent within 5 to 10 years can be achieved without any assumptions in increased growth.*"[162] However, applying the report's first Fiscal Rule (to get the deficit below 3% within 10 years) and deficit reduction model (for spend growth to be *sufficiently* lower than GDP growth to achieve this) can only lead to real spending growth if real GDP growth is greater than 1%.[163]

In fact, if we remove the cost saving optimism from the Growth Commission's assumptions (which is what causes such a large step down in spend/GDP in the graph above) then spend growth would have to lag GDP growth by 1.5% to still get the deficit under 3% within 10 years.

[159] Our key sanity check is not just the deficit outcome but the implied debt/GDP after 10 years. In our simple model this comes out as 36%, identical to the figure the Commission quote [B12.18]. It should be noted that this simple model implicitly and somewhat simplistically assumes that revenue/GDP is not affected by spend/GDP

[160] It looks as if the Growth Commission are using GDP including N sea oil in the denominator – that is what we have assumed (it is not a major factor when it comes to the conclusions drawn)

[161] Note that the GDP figure used for the denominator in this graph is GDP including North Sea Oil.

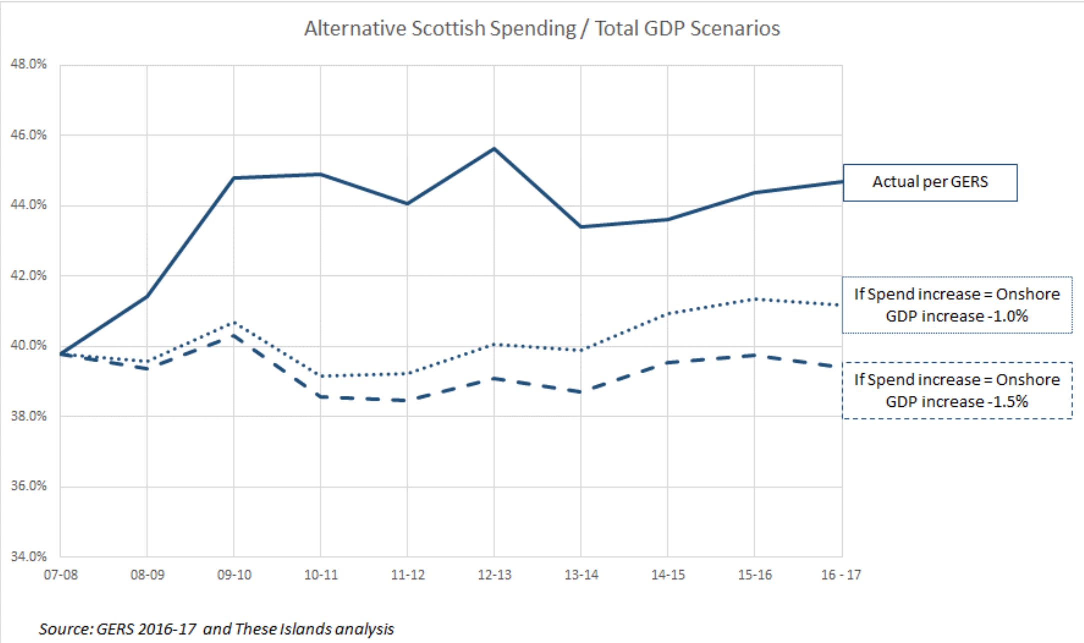
[162] 3.192 – "within 5 to 10 years" is a strange choice of words given that "within 10 years" is clearly what is meant

[163] Assuming a starting deficit of 5.9% and revenue/GDP being unaffected by spend/GDP

Claims, like those made by the First Minister, that the Growth Commission recommendations would have "eradicated austerity" over the last 10 years simply do not stand up to scrutiny. Average real onshore GDP growth in Scotland over the last decade has been just 0.8%[164] and 10 years ago the onshore deficit was over 8.7%.[165] This means that strictly applying the Growth Commission model – which requires spending growth to be "*limited to **sufficiently** less than GDP growth*"[166] to get the deficit below 3% within 10 years would actually have required spending growth to be c.1.5% behind GDP growth.

A simple graph (Figure 5) shows the difference between what actually happened to spend/GDP under 'Westminster austerity' and what would have happened if spending growth had been constrained to either 1.0 % or 1.5% less than GDP growth over that period.[167]

Figure 5



The impact of applying the Growth Commission's recommendations retrospectively is unsurprising – they lead to materially less spending in Scotland than actually occurred over the last decade.

- **If spending growth had lagged GDP growth by 1.0% over the last decade:** total cumulative expenditure in Scotland would have been £53bn less than actually occurred and in 2016-17 spending would have been running at a rate of £5.6bn pa

[164] Using 2016-17 GERS figures and applying the HMT GDP deflator
[165] 8.7% based on total GDP, 10.4% based on onshore GDP
[166] 3.187
[167] The denominator used here is total GDP (including North Sea) whereas the GDP growth used to define spend growth is onshore only – this is why spend/GDP actually goes up in the 1% scenario, because offshore GDP declined over this period.

(7.8%) less. The onshore deficit would have been reduced to 4.8% (i.e. the first Fiscal Rule would still not have been met)

- **If spending growth had lagged GDP growth by 1.5% over the last decade:** total cumulative expenditure in Scotland would have been £58bn – £66bn[168] less than actually occurred and in 2016-17 spending would have been running at a rate of £8.4bn pa (11.8%) less. The onshore deficit would have been reduced to 3.0% (i.e. the first Fiscal Rule would have just been met[169])

This finding is intuitively obvious given Scotland's onshore deficit was actually 8.4% in 2016-17. The Growth Commission's first Fiscal Rule would have required that to be brought down below 3% over the preceding 10 years by limiting increases in spending. The net result would therefore have inevitably been a dramatic reduction in spending, far beyond anything seen under what the Growth Commission refer to as the "austerity model pursued by the UK".

The Commission tacitly accepts the need for disciplined control of spending to reduce the deficit. As well as an oblique reference to Ireland's *"necessary actions to deal with the financial crisis"*[170], the report states:

> *"Successful improvements in public finances have generally been structured with an emphasis on spending control [...] the empirical work consistently finds that deficit reductions that are successful [...] tend to focus on spending control policies that are clear"* – [B7.26]
>
> *"Countries with stronger budgetary processes were more successful in reducing debt. It is notable that countries that implemented stronger budget processes also had a better fiscal experience through the crisis"* – [B8.6]

Indeed by not proposing to reverse any of the recent or planned spending cuts[171], the Commission implicitly accepts that these are a necessary (but not sufficient) condition for making the Scottish economy fiscally sustainable on a stand-alone basis. The report states *"planning for additional cuts over and above those already planned is likely to be counter-productive"*[172], but makes no proposals to reverse any of the previous cuts. This means that the Commission makes no plans for spending increases to reverse such policies as the benefits cap, the 2-child tax credit cap or increases to the state pension age.

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168 The lower end of the range is arrived at by smoothing the spending figures to reflect the Growth Commission's 'over the business cycle' caveat (i.e. spending is not reduced as aggressively when short-term dips occur in GDP growth)
169 Which confirms the 1.5% figure is correct
170 A3.56
171 In fact the Commission explicitly states *"Scotland's replication of UK budget spend currently allocated to Scotland in a number of areas is assumed to be unchanged for our analysis including welfare, pensions, economic development and scientific and university research funding."* [3.140]
172 B4.20

We note that the alternative of not reducing real terms spending but instead hoping that increased spending will act as a fiscal stimulus to drive growth (sufficiently to still reduce Spend/GDP) is hardly mentioned in the report. It does appear as a rather equivocal and non-committal final recommendation in Part B (recommendation No. 43):

> *"Transitionary Fiscal Stimulus a fiscal stimulus to growth should be considered and consulted on depending on the prevailing economic circumstances and the perspectives and price required by debt providers."*

To summarise

- The anti-austerity rhetoric is completely disconnected from the detail of the commentary and recommendations.
- If applied retrospectively, the recommendations would have led to far greater austerity than Scotland has experienced over the last decade and led to roughly £60bn less spending.
- The commission has claimed to reject the existing 'austerity model' but has replaced it with one that is necessarily harsher. *Necessarily* so because, unlike the situation for Scotland remaining within the UK, the Commission suggests than an independent Scotland would *have to* get its deficit below 3% within a decade.
- Based on realistic assumptions, the Commission's recommendations would almost certainly lead to many years of even greater austerity for an independent Scotland.

We are not alone in drawing these conclusions – commentators and analysts from across the political spectrum share our view:

- *"It's a continuation of austerity. If public spending growth is one per cent less than GDP growth, that's austerity."* – David Phillips, IFS associate director[173]
- *"In fact, a unionist blogger did the maths on what Growth Commission rules would have done over the Tory austerity years and it would actually have been worse. We quickly ran the numbers to check – and I'm afraid to say he is right"* – Robin McAlpine, Common Weal[174]
- *"what the Commission is saying by adopting these objectives, which will cruise all others in the report, that Scotland should welcome austerity in its place"* – Richard Murphy, Tax Research UK[175]
- *"[The Growth Commission] does not reject austerity in reality. It would create the conditions for austerity politics to thrive"* – Jonathon Shafi, Co-founder of the Radical Independence Campaign[176]

[173] https://www.holyrood.com/articles/news/ifs-independent-scotland-%E2%80%98would-face-continued-austerity%E2%80%99-under-growth-commission
[174] https://www.commonspace.scot/articles/12854/robin-mcalpine-yes-bikers-yes-bankers-why-growth-commission-gets-its-strategy
[175] http://www.taxresearch.org.uk/Blog/2018/05/25/the-scottish-growth-commission-gets-its-economics-very-badly-wrong/
[176] https://twitter.com/Jonathon_Shafi/status/1003632589465415680

6. Aiming Too Low

The Commission's first Fiscal Rule (to get below a 3% deficit within a decade) is not sufficiently aggressive.

The report notes that *"Small advanced economies have made fiscal prudence a strategic priority"*[177] and none of the Commission's chosen SAEs runs a deficit as large as 3% – in fact most run a surplus.[178]

The report also notes[179] that the following fiscal rules apply in the three countries it recommends we most seek to emulate:

- Denmark: *"the annual structural public balance must not exceed a deficit of 0.5% of GDP at the time of the budget proposal for a given year unless extraordinary circumstances are present"*
- Finland: *"the government is committed to adjust if the debt/GDP ratio is not shrinking or if the deficit stands above 1.0% of GDP"*
- New Zealand: *"Maintaining rising operating surpluses (before gains and losses) over the forecast period so that cash surpluses are generated …"*

Whilst the EU's Growth and Stability Pact defines a deficit threshold of 3%, the report itself notes *"Its successor, the European Fiscal Compact, specifies limits of 60% debt and 0.5% deficit as measured across the cycle"*.[180]

The IFS, with customary understatement, has observed that *"A deficit of almost 2.6% of GDP might be sustainable for a large country with good growth and a long track record of borrowing on international markets. For a new and relatively small country it may not."*[181]

The report itself observes that a sensible long term fiscal target should be *"fiscal balance over the cycle"* or *"if a 2% GDP growth rate can be sustained, then a deficit limit of around 1% of GDP may be appropriate in the longer term"*.[182]

The Commission aspires for Scotland to achieve EU membership[183], for which having an independent currency is effectively a prerequisite.[184] One of the report's six tests for being able to introduce a separate Scottish currency is *"does Scotland have sufficient*

[177] A3.32
[178] Figure 7-1
[179] Figure 8-1
[180] B7.11
[181] https://www.ifs.org.uk/publications/13072
[182] B8.67
[183] B8.63
[184] The formally stated economic accession criteria is *"a functioning market economy and the capacity to cope with competition and market forces"* https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/accession-criteria_en

reserves to allow currency management" [185]– running a fiscal surplus would seem to be a precondition for building up such reserves.

All of the report's analysis optimistically assumes that, despite servicing its inherited share of UK debt via a 'solidarity payment', an independent Scotland would be considered to be starting life 'debt free'.

To be fiscally sustainable it is therefore reasonable to suggest that, using what are already demonstrably optimistic assumptions, the Growth Commission should be able to show how an independent Scotland would move into surplus. In fact, the best figure the Commission projects after fully 10 years of independence (and likely austerity) is a deficit of 2.6%.[186]

[185] 3.212, test 4
[186] Figure 12-2

7. The Missing Model

The report doesn't attempt to model the likely impact of its recommendations.

The Chair's introduction states that *"Bridging the gap between potential and performance is the purpose of this report*".[187] If this is the purpose of the report then unfortunately it fails.

Without costing the proposals and making assumptions about how much they could realistically improve Scotland's growth rate by, it's impossible to judge whether the proposed *"Framework & Strategy for the Sustainable Public Finances of an Independent Scotland"*[188] adds up to a coherent plan. Whether the ideas the report has documented are capable of "bridging the gap" is a question left unanswered.

The "Strategy" in fact amounts to little more than a laundry-list of possible ideas and a long list of process recommendations. From a process perspective the Commission recommends:[189]

- <u>Three further Commissions</u>: Productivity Commission, Infrastructure Commission and Gender Pay Equality Commission
- <u>Seven separate Reviews:</u> Universities Growth Strategy Review, Government Led Innovation Review, Comprehensive Review of Scottish Taxation System, Comprehensive Review of Inherited UK Spending Programmes, Standing Council on Scottish Public Sector Financial Performance, National Balance Sheet Review and a Comprehensive Review of policy relating to long-term risk bearing projects
- <u>Five new Agencies:</u> Inward Investment Agency, Innovation Agency, Economic & Fiscal Forecasting Agency, Asset & Liability Management Office and an agency "tasked with creating a strategy for engagement and transitioning of the staff of international governments and multi-national organisations to Scotland"
- <u>Two new Institutions</u>: the Scottish Central Bank and a Scottish Financial Authority
- <u>A National Brand Strategy</u>

As far as actual strategy recommendations go, the report largely talks in unquantified generalities. Sometimes the scale of potential upside is asserted, but nowhere are all the costs associated with these upsides estimated or their likely total impact calculated.

- When talking about supporting greater R&D and innovation the report stops short of committing to any actual investment figures: *"Many small advanced*

[187] 2.8 (p.6)
[188] Part B. Note how independence is again presumed
[189] Some of these are recommended in Part A of the report, some in Part B

economies invest very heavily in R&D” [A3.14]; *“it is likely that a net investment will be required”.* [A6.142]

- Tax policy is only discussed in broad generalities. The possibility of competing on low corporate tax rates is dismissed, but the likely impact of other possible tax moves is left unquantified: *“using taxation as a tool for economic development but not competing as a low tax location”* [3.58]; “*We are interested in the potential to tailor the Dutch R&D tax credit scheme, enhance incentives for longer term equity investment and improve capital allowances. While we do not consider that competitive use of profit taxation (corporation tax) is an optimal strategic tool, we do recommend that the headline rate of corporation tax should not rise above the level prevailing in the rest of the UK. As with all taxation the impact of the overall structure on both the tax base and revenue generation should be carefully assessed to ensure the more effective system is deployed.”* [A6.212]
- Details of how Foreign Direct Investment will be attracted are vague: *“an openness to foreign direct investment (like Ireland), but competing not on labour costs or tax incentives, but on access to markets and to the highly skilled workforce and university sector”* [A3.82]
- The importance of ‘human capital’ is discussed but the actual investment required is not, despite the report observing: *“small advanced economies are characterised by heavy investments in knowledge, innovation and human capital (skills, retraining).”* [A3.13]; *“An export-based growth strategy will therefore require that skills gaps in sales and languages are addressed”* [A6.85]
- The potential upside from Enhanced Digitalisation [Table 6-4] is mentioned – but the report[190] that table is drawn from *“does not seek to identify the infrastructure investment that is required”* and neither does the Commission
- Some figures are scaled simply by assertion: *“Increasing overseas exports from 20% of GDP to 40% of GDP would be a reasonable target to set […] and would be expected to generate additional taxation revenues of some £5 billion each year.“* [3.89]
- Some figures are scaled more robustly, but as with all the recommendations they are not then included in any total: *“The Civil Engineering Contractors Association (CECA) recommends that investment in infrastructure should be maintained at least at 0.8% of GDP. For Scotland that would be £1.2 billion per annum and given the historic under-investment in infrastructure, there may be a case for substantially higher levels of investment over 5-10 years.” [A6.159]*

Some of the building blocks may have been defined, but a strategy that would act as the bridge between potential and performance has not been constructed.

190 https://www.scottishfuturestrust.org.uk/storage/uploads/impact_of_digitalisation_in_scotlandcompressed.pdf

The report's Chair has stated clearly *"we don't put assumptions for growth into the numbers"*[191] and the report itself explains *"The recommendations set out in this part of the report [Part B, the 'Strategy for the Sustainable Public Finances'] do not rely on increasing the growth rate."*[192]

The report does talk about "*economic aspiration*"[193] and *"ambitious growth goals"*[194], but those who have interpreted these future growth figures in the report as 'assumptions' are apparently mistaken (presumably because they are never used as assumptions for modelling purposes[195]).

> *"Growth goals: The Strategy should include globally ambitious growth goals, to i) First 10 years: catching up with the small advanced economies average growth rate (currently 2.5%[196]) (ii) Years 10 to 25: closing the GDP per capita gap with the small advanced economies (with period of 3.5% growth) (iii) maintaining a GDP per capita position in line with the top half of the small advanced economies group."* [3.98 and repeated A3.99 & A7.1]

These 'goals' are unjustifiably ambitious. Not only do they assume that an independent Scotland would grow at rates that can only be justified by including low tax, high income-inequality models in the SAE cohort, but these goals suggest an independent Scotland would ***outperform*** **that SAE average by fully 1% of GDP growth pa for 15 years**.

The idea that an independent Scotland would *outperform* the optimistic 2.5% pa figure by a further 1% pa for 15 years is an assumption that appears to come from nowhere. We presume it has been arrived at because if you compound a 1% difference over 15 years then you get 16% superior growth. The Commission rather arbitrarily chose the Netherlands as the aspirational GDP/capita target in Part A of the report and this was 14% greater than Scotland's. If we ignore the fact that, by implication, the growth gap would be growing during the first 10 years (while Scotland is playing catch-up on growth), then this assumption would roughly close *today's* gap in GDP per capita between Scotland and the Netherlands - but only if there is no differential in rate of population growth.

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[191] BBC Sunday Politics Scotland, 27 May 2018
https://www.youtube.com/watch?v=ad2NRtYnbs0&feature=youtu.be&t=7m32s

[192] 3.108

[193] *"Over a medium-term horizon, the economic aspiration for Scotland can be framed around sustaining GDP growth at above-average rates to converge towards the income frontier for small advanced economies."* [A1.90]

[194] A3.99

[195] These "goals" being distinct from the assumptions that *were* used by the Commission in their attempt to demonstrate how their spending-restraint driven deficit reduction strategy could lead to real spending growth (see B12.18)

[196] This is the average real GDP growth rate for the GC's SAE cohort from 2000 –to 2016, so we presume these figures are in real terms and that is how they have been arrived at – the IMF forecast 2016 – 2023 growth of 2.4% for this cohort and 1.9% for the LAEs

Over the last decade Scotland's population growth has averaged 0.5% pa, but the Commission offer no estimate as to the incremental increase in rate of population growth they either aspire to or expect. What we can be sure of is that if incremental improvement in GDP is driven by an incremental increase in population, then the rate of improvement in GDP per Capita will be less than the rate of improvement in GDP.

The failure of the Growth Commission to make any assumptions about GDP/Capita is startling when we consider how strongly they recommend accelerating population growth: *"The attraction of economic migrants (from identified target groups) should be one of the top priorities of Scottish Government economic policy."*[197]

This is vitally important because, as the report observes: *"The overall level of GDP in a country is less important to individuals than the level of GDP per capita."*[198] By providing an incremental GDP growth goal without any assumption about incremental population growth, we are left unable to judge what even the Commission's aspirational goals would deliver in GDP/Capita terms.

[197] 3.68
[198] A1.41

8. Currency – an Unsolved Conundrum

The report's currency recommendation is symptomatic of the weakness of the economic case for independence.

We have seen that the Growth Commission is unrealistically optimistic with its GDP per capita and GDP growth rate 'gap' assumptions, clearly over-estimates the savings available on day one, is extremely optimistic about the costs to build (and run) an independent Scotland's administrative functions and fails to take into account any of the downsides of separation.

Even with all of this transparent optimism and despite recommending (implicitly at least) greater austerity than Scotland has experienced in recent years, the Commission fails to show how Scotland could get to the fiscal surplus that would likely be required to create an independent currency.

The Commission has therefore had little choice but to recommend *"that the currency of independent Scotland should remain the pound sterling for a possibly extended transition period".*[199]

Whilst this strategy of 'sterlingisation' may be the most pragmatic solution to the currency problem that independence would create, it would necessarily constrain an independent Scotland's economic freedom, as several highly credible commentators have observed:

> *"[rUK] can't prevent the Scots from using the pound, just as the USA can't stop Ecuador from using dollars. But the lesson of the euro crisis, surely, is that sharing a common currency without having a shared federal government is very dangerous"* - Joseph E. Stiglitz, University Professor at Columbia University, recipient of the 2001 Nobel Memorial Prize in economics[200]
>
> *"I do not believe that [sterlingisation] would be seen as a stable and continuing position for a country as substantial as Scotland"* – Professor Jeremy Peat OBE FRSE and Fellow of the Chartered Institute of Bankers in Scotland[201]
>
> *"Scotland would have no control over money supply, relying on importing pounds through its balance of payments. It would likely have to run trade surpluses, which would require internal adjustment to achieve, depressing domestic demand and crushing growth"* - David Folkerts-Landau, chief economist at Deutsche Bank[202]

[199] 3.203
[200] https://krugman.blogs.nytimes.com/2014/02/24/scots-wha-hae/
[201] http://www.parliament.scot/parliamentarybusiness/report.aspx?r=9200&mode=html
[202] https://blogs.spectator.co.uk/2014/09/deutsche-banks-devastating-analysis-scottish-independence-would-bring-austerity-on-a-scale-never-seen-before/

> *"a new Scotland would have to run large budget surpluses for a long time to build up what would be a foreign currency reserve adequate to provide a makeshift lender of last resort for its banking sector"* - Professor Anton Muscatelli, University of Glasgow[203]

> *"Scotland couldn't keep borrowing to pay for spending in excess of its tax take – the markets wouldn't allow it, especially a new state with no financial track record, with no central bank and borrowing in a foreign currency if sterling is adopted."* – Brian Ashcroft, emeritus professor in economics, University of Strathclyde[204]

The implications for the Scottish financial services sector in particular could be devastating:

> "T*here will be no safety net for Scotland's banks. There may be few Scottish banks in any case, as the larger ones would probably move south of the border to protect shareholders and reassure customers*"[205] - Dame DeAnne Julius, former Monetary Policy Committee member and Bank of England court director

> *"The implications for Scotland's financial-services industry could hardly be worse. Scotland is host to a large financial sector, which contributes 12.5% of its GDP. With no central bank supporting them, its banks and insurance companies would be seen as riskier investments and the cost of their borrowing would rise. Many would shift their headquarters to England taking highly paid staff and tax revenues with them."*[206] – The Economist

In part A of the report, the Growth Commission make a point of singing the praises of Scotland's Financial Services sector.[207] ONS employment data[208] shows that 192,152 people are employed in the Financial Sector in Scotland. With just over 8% of the population, Scotland has 19% of the UK's Financial Sector jobs. But by the time we get towards the end of Part C, the Commission appears to accept the loss of large parts of the financial services sector in Scotland as an acceptable price to pay for independence:

> *"Financial support would not extend to holding companies of retail banks […] It is likely that the result would be that some companies would move their domicile to England in response, in expectation of broader support from the Bank of England.*

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[203] https://www.ft.com/content/e635505a-328f-11e4-a5a2-00144feabdc0
[204] http://www.scottisheconomywatch.com/brian-ashcrofts-scottish/2013/07/has-scotland-already-spent-its-oil-fund.html
[205] https://www.ft.com/content/e635505a-328f-11e4-a5a2-00144feabdc0
[206] https://www.economist.com/finance-and-economics/2014/09/11/no-country-for-old-money
[207] *"The financial services sector in Scotland has a long history and global reputation, particularly in high value areas such as insurance and asset management."* [A1.13]
[208] https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/adhocs/008061countandemployeesinthefinancialsectorbyregionanddistrict

> *[…] Indeed most, if not all, of the banks have already made clear in public statements that they would be headquartered in London for the purposes of regulation in the event of independence."*[209]

The Growth Commission makes no attempt to quantify the economic impact of their proposed currency strategy or to quantify the reserves that would be needed before being able to consider creating an independent currency. The scale of reserves that an independent Scotland would need to accumulate to support its own currency has been estimated at between £30 billion and £300 billion.[210]

The Commission also fail to address the issue that having a stable, independent currency would very likely be a requirement for an independent Scotland to join the EU.[211]

> *"An accession country must have an independent central bank & a currency. It must have policies directed at price stability, make exchange rates a matter of common concern & an intention to join the euro. So using the £, Scotland can't do this"*[212] – Kirsty Hughes, Director, Scottish Centre on European Relations

Independence would create a currency problem. The Growth Commission offers perhaps the only credible solution given the fiscal constraints that exist – but this would still damage and constrain the Scottish economy compared to the alternative of simply remaining in the UK.

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[209] C3.28
[210] https://www.scotsman.com/news/politics/separate-scottish-currency-could-cost-as-much-as-300bn-1-4743731
[211] The formally stated economic accession criteria is "*a functioning market economy and the capacity to cope with competition and market forces*" https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/accession-criteria_en
[212] https://twitter.com/KirstyS_Hughes/status/1001014056306782208

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9. Making the Case for Union

The Commission, by implication, makes a strong case for Scotland staying in the UK

Despite being highly optimistic with its 'pro-independence' assumptions and simply ignoring the potential downsides of separation from the UK, the Commission has succeeded in highlighting some of the many advantages that Scotland enjoys from being part of the Union.

The report notes that smaller economies are more volatile and must be more fiscally conservative than large economies[213] and recognises that an independent Scotland would be unable to sustain a deficit of greater than 3% for more than a decade. But the report also makes the point that the UK – as a *large* advanced economy – has been able to run relatively large deficits:

> *"[…] it is anticipated on the basis of OBR and other independent forecasts that the GERS estimate of Scotland's deficit would be 7.1% of GDP by 2021-22. This would have to come down. However, it should be noted the UK has had a deficit at or above this level in six of the last ten years."* [3.134]

This observation is empirical proof that a larger economy with its own stable currency[214] is able to avoid the levels of severe austerity that – the Commission tacitly accepts – smaller economies have to endure to get their deficits rapidly under control.

Not only are the fiscal constraints less onerous for a large economies, but regions of a larger economy are able to benefit from the average performance of the whole. The report implicitly acknowledges this when it states *"Scotland's fiscal position makes very little difference to the overall fiscal balance of the UK"*.[215] This is the beauty of pooling and sharing: not every part of the UK has to be fiscally sustainable on a stand-alone basis, only the whole of the UK does.

In 2016-17, the UK's deficit was 2.4% of GDP and by 2021-22 the IFS forecast a UK deficit of just 0.7% (at the same time as they forecast a Scottish deficit of 6.7%).[216]

By staying in the UK, Scotland would benefit from the spending freedom that having a deficit as low as 0.7% creates. By leaving the UK - as the Growth Commission has helpfully illustrated - Scotland would face at least a decade of further austerity just to (hopefully) get the deficit down to 2.6% (a figure still worse than the UK deficit Scotland shares today). [217]

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[213] *"The greater volatility that small economies can experience also strengthens the case for fiscal Conservatism"* [B8.33]
[214] One of the reasons the report offers for adopting Sterling is to *"maximise certainty and stability"*[C1.8]
[215] B4.36
[216] https://www.ifs.org.uk/publications/9273
[217] 2016-17 GERS deficit for total UK is 2.4%

That Scotland currently benefits from UK-wide pooling and sharing is beyond dispute. There are various ways of calculating the figure[218], but the effective fiscal transfer Scotland received from the rest of the UK was between £9.5bn and £10.4bn in 2016-17. That's between £1,750 and £1,900 for every man, woman and child in Scotland.

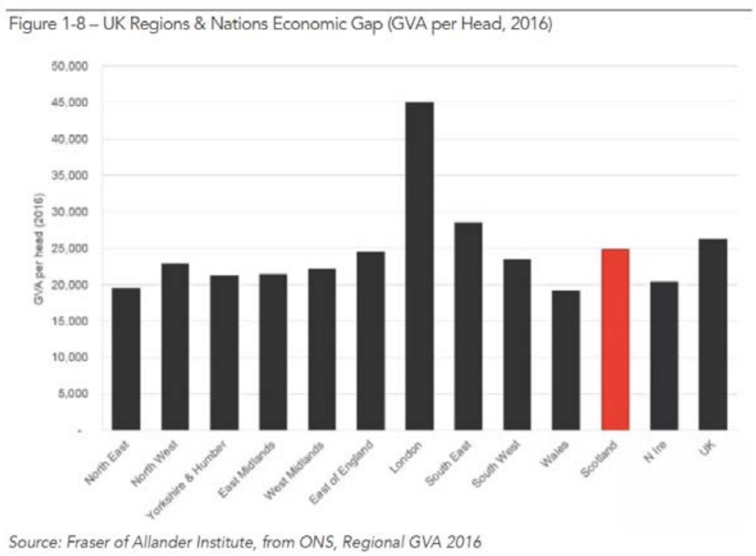
It is surely no coincidence that the growth in GDP per capita the Commission aspires to is scaled as having a revenue impact of £9bn pa.[219] The Commission's optimistic assumptions imply it would take 25 years to achieve that aspiration – so that's optimistically 25 years to not quite replace the fiscal transfer Scotland would be guaranteed to lose on day one.

The Growth Commission attempts to suggest this fiscal transfer and Scotland's greater deficit is evidence of 'under-performance' on Scotland's part:

> *"In political terms, we present a choice for making Scotland's public finances sustainable, purposefully and by our own efforts. It is for others to then judge whether this is preferable to having them ordered in the same manner that got us to the* ***current under-performing position*** *in the first place."* [B1.15]

This assertion of under-performance is undermined by the Growth Commission themselves when they observe (Figure 1-8, our Figure 6) *"Scotland's economic output per head is the best of the UK nations and regions, outside of London and the South East."*[220]

Figure 6

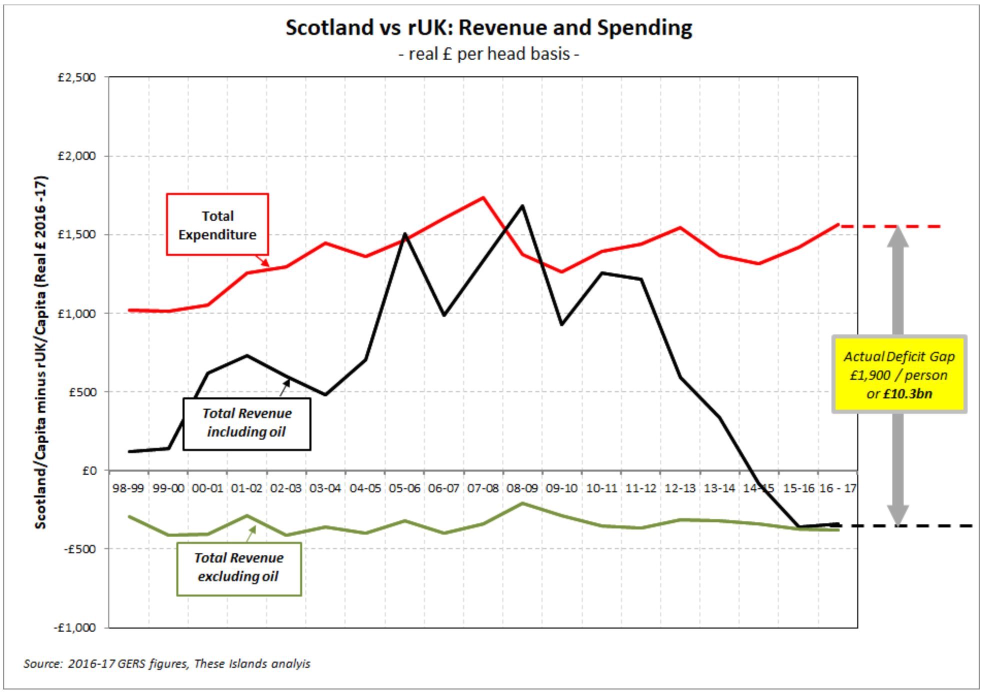


[218] The IFS uses percentage of GDP and compares Scotland with all UK (including Scotland); this is appropriate for working out 'how much worse/better off Scotland would be'. To calculate the effective fiscal transfer, it is more accurate to compare Scotland with rUK (the rest of the UK excluding Scotland) which gives the higher figure. It can be argued that per capita comparisons are preferable to percent GDP ones (as debt is implicitly shared on a per capita basis, not a GDP basis) but this makes no material difference to the calculations.
[219] 3.32
[220] A1.64

The reason for this apparent contradiction is that Scotland's 'performance' in terms of onshore **revenue** generation per capita is broadly in line with the rest of the UK, the 'under-performance' the Commission refers to is based on the observed GERS **deficit**, which is explained primarily by Scotland's higher public **expenditure** per capita.

This is a long-term issue which oil revenues have previously masked, as Figure 7 illustrates.

Figure 7



A quick analysis of the GERS figures reveals where this difference in spend per capita comes from (Figure 8);

Figure 8

Spend per Capita, 2016-17

	£/capita		Difference	
	Scotland	rUK	£/capita	%age
Social protection	4,400	3,992	408	10%
Education and training	1,510	1,312	199	15%
Housing and community amenities	312	147	164	112%
Health	2,342	2,186	156	7%
Transport	585	439	146	33%
Agriculture, forestry and fisheries	192	72	120	168%
Enterprise and economic developmer	193	79	113	143%
Public and common services	280	192	87	45%
Recreation, culture and religion	254	170	84	50%
Environment protection	223	167	57	34%
Public order and safety	508	454	54	12%
Accounting adjustments	948	912	36	4%
Science and technology	82	57	24	42%
Employment policies	42	37	5	13%
Public sector debt interest	601	600	2	0%
Defence	565	563	1	0%
International services	150	149	0	0%
EU Transactions	(12)	80	(92)	-115%
Total	**13,175**	**11,610**	**1,566**	**13%**

Source: GERS 2016-17, These Islands Analysis

Differences in per capita expenditure cannot (by definition) be explained by those shared UK costs that are allocated to Scotland on a per capita basis[221], but the Commission has focused exclusively on those areas and simply ignored all of the areas where relatively higher spending is incurred *in* and specifically *for* Scotland.[222]

Given that higher per capita spending is the main reason for the 'under-performance' the Commission observes, we find it odd that it implies this is somehow the fault of the current constitutional settlement and doesn't investigate or seek to explain it.

The Commission doesn't attempt to suggest that independence would change Scotland's per capita spending in these areas, but it does allude to the fact that the causes may be structural:

> *"Given the nature of Scotland's economy, society and geography there is no doubt that the challenges facing the country are distinct from many parts of the rest of the UK."* [B1.17]

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[221] Note that debt interest, defence and international services show no material difference precisely because they are allocated on a per capita basis (bar some very minor technical adjustments)

[222] Figure 8 shows this higher spend per capita in Scotland occurs in almost all spending categories

> *"At the same time the delivery of public services can be more expensive than in smaller urbanised geographies."* [B1.18]

An important principle of pooling and sharing is that high 'cost-to-serve' areas are subsidised by lower 'cost-to-serve' areas. Scotland - with its low population density[223], remote and island communities and challenging demographics[224] - benefits from this principle within the UK (via the Barnett Formula). Whether this greater public spending in Scotland can be fully justified with structural explanations is open to debate; that Scotland receives higher public spending per capita than the rest of the UK is not.

It's a simple statement of fact that separation from the UK would reduce the size of Scottish companies' domestic market by 90%.[225] The downside of this is alluded to by the report when discussing SAEs' greater need for 'Active International Engagement':

> *"the domestic market in small advanced economies is too small to get the required levels of scale and specialisation."* [A3.8]

So the Commission has helped us see how being in the UK allows Scotland: to enjoy the advantages of a shared currency and large domestic market; to avoid the fiscal constraints that would inevitably apply were Scotland a stand-alone economy; and to benefit from levels of public spending that would otherwise be unsustainable.

The greater fiscal freedom that an economy of the UK's size enjoys also offers different choices that the Commission, by assuming independence, were unable to consider.

Without attempting to judge the pros and cons of the strategy here, it's patently obvious that the UK (with its own stable currency and a deficit forecast at just 0.7% by 2021/22) has more capacity for fiscal stimulus that an independent Scotland could possibly have. The Commission's report effectively shows us that those who stand 'against austerity' cannot also stand in favour of independence (unless they are prepared to sacrifice fiscal credibility). The only credible route to avoiding austerity in Scotland is surely to elect a UK government that would at least have the capacity to pursue fiscal stimulus as an alternative.

Faced with this evidence of the benefits of Scotland remaining in the UK, we find ourselves asking what the economic benefits of independence are that makes the Commission so convinced that independence is 'the answer'.

We've seen that the evidence that we would somehow achieve greater economic growth just by dint of becoming a small advanced economy is tenuous at best,

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[223] The 2013-14 GERS report observed *"lower population density in Scotland relative to the UK [...] increases the cost of providing the same level of public service activity, particularly in areas such as education, health and transport"* http://www.gov.scot/Publications/2015/03/1422/8

[224] *"the dependency ratio of Scotland is projected to increase from 58 dependants per 100 working population in 2014 to 67 per 100 in 2039. By contrast, the UK's dependency ratio was 31 per 100 working population in 2014 and is projected to rise to 37 per 100 in 2039"* – The Demography of Scotland https://www.populationmatters.org/documents/evidence_to_scottish_affairs_committee_260216.pdf

[225] The Scottish population is 8.3% of the UK's population, so 91.7% if we're being picky

particularly as the necessity to reduced public spending would be likely to harm growth, not improve it.

The report talks a great deal about the downsides of the UK leaving the EU, but the trauma of Scotland separating from a much deeper, 300+ year-old union would inevitably be so much greater. Those who view the UK leaving the EU as a 'wrong' which justifies Scotland leaving the UK, would do well to remember the old adage: 'two wrongs don't make a right'.

Apart from the obvious greater economic trauma that exiting this closer union would entail, it is far from clear that an independent Scotland would be able to rejoin the EU, particularly given the currency question. The report does not address this issue and fails to test whether the ideas they suggest for economic growth would even be possible as an EU member state.

In fact, the report reluctantly concedes that:

> *"While this report considers the public finances of an independent Scotland, it is not inconceivable that many of the positive recommendations detailed here could be implemented in advance of such a move."* [B1.22]

The words 'in advance of' could easily be replaced with 'instead of', which strikes us as a rather enticing option.

The Growth Commission's work succeeds in illustrating many of the downsides of independence while highlighting the benefits of our inevitably flawed but enduring 300 year-old union. An approach which seeks to grow Scotland's economy by constructively building on the strengths of this union would seem to us favourable to one that seeks to destroy it.

Using the devolved powers Scotland already has (or may develop) to pursue the Commission's growth ideas without creating the unnecessary disruption, uncertainty and further austerity that separation from the UK would entail would be a logical and constructive way of taking forward the Commission's work.

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Modern Britain has been one of the most stable countries in the world. For the past 300 years, the union between England and Scotland – founded in turn upon the much older union between England and Wales – has held fast. Recently, though, the future of the United Kingdom has become a topic of increasingly convulsive debate. Two referendums have served as lightning rods for existential questions about the country's identity. The 2014 referendum on Scottish independence put the very survival of the United Kingdom at stake; last year's Brexit referendum has left the question of how its constituent nations should relate to one another very much up for grabs. These are unsettling times – but also exciting ones.

These Islands is a forum for debate founded in the conviction that no crisis should be allowed to go to waste. It stands unabashedly for the view that more unites the three nations of Great Britain than divides them, and that good relations between the various communities of Northern Ireland, Great Britain, and Ireland are all the more important to work for in the wake of Brexit. Accepting that there is a pressing need for recalibration, it does so with a sense of optimism and relish. Enthusiastic about the Union, it is enthusiastic as well about local identities and loyalties. It recognises that to explore a British sense of identity is also to explore the other identities that people in these islands have, and that the plural nature of the United Kingdom, far from constituting a weakness, is its greatest strength.

As a forum, These Islands is for people of all political traditions. Both right and left in the United Kingdom, after all, have derived their principles from its various corners. They bear the imprint of Edmund Burke and Benjamin Disraeli; of Robert Owen and Keir Hardie. Simultaneously, we will work to ensure that the provenance, reliability and limitations of data relevant to the future of the United Kingdom is clearly laid out. Informed and constructive debate on such a vital topic is impossible without a robust understanding of the relevant facts.

We are about much more than politics, though. The wildlife of these islands and their seas respect no borders; the shared history of Great Britain and Ireland is far older than the United Kingdom; the arts and creative industries which have made our country such a cultural powerhouse are our common heritage. All these, and other topics too, will be our themes.

We provide a forum for everyone interested in what makes Britain, Britain – and how a future that works to the benefit of everyone in these islands can best be forged.

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