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Achieving fiscal sustainability: alternative scenarios for Scotland

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FUTURE OF THE UK AND SCOTLAND

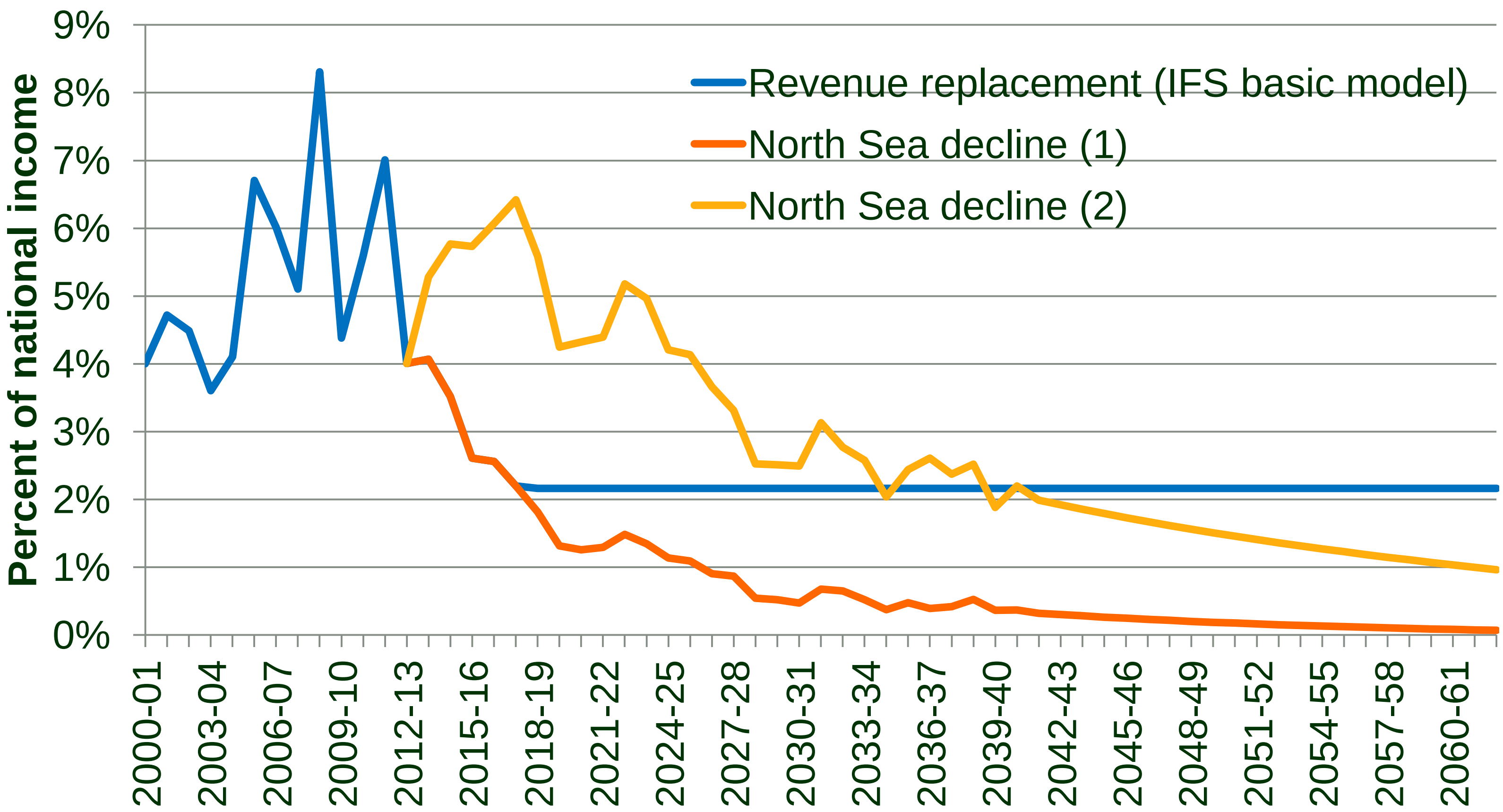
Overview

- IFS basic model applies OBR assumptions about the UK to Scotland
  - Suggests an independent Scotland would have a greater and more immediate long-run fiscal problem than the UK as a whole
- “Fiscal gap”: to get public sector debt back to 40% of national income by 2062–63
  - Scotland: requires 4.1% of national income tightening
  - UK: requires 0.8% of national income tightening
- Results are sensitive to a number of assumptions
  - North Sea production and revenues; migration; productivity growth; debt allocation; interest rate on public sector debt
- Show sensitivity to a variety of assumptions
  - Main message – that Scotland faces tougher long-run fiscal challenges than UK as a whole – remains

North Sea revenues

- Basic model:
  - Decline based on OBR forecast to 2017–18
  - Constant as % national income thereafter
- Revenues likely to decline by more than this in the long-run
  - Basic model assumes NS revenues remain at 2.2% of Scottish GDP
  - OBR central projection is for revenues to fall to 0.4% of GDP by 2040
- Revenues from the North Sea might be higher in the medium-term
  - Scottish Government suggests production and prices will be higher in medium-term, leading to higher revenues
- Alternative scenario: ‘North Sea decline (1)’
  - North Sea revenues decline as suggested by OBR central forecast
- Alternative scenario: ‘North Sea decline (2)’
  - Based on most optimistic, scenario 5, from Scottish Government, *Oil and Gas Analytical Bulletin*; then declines over longer-run

Alternative forecasts for North Sea revenues



Source: Amior, Crawford and Tetlow (2013a), Figure 3.5.

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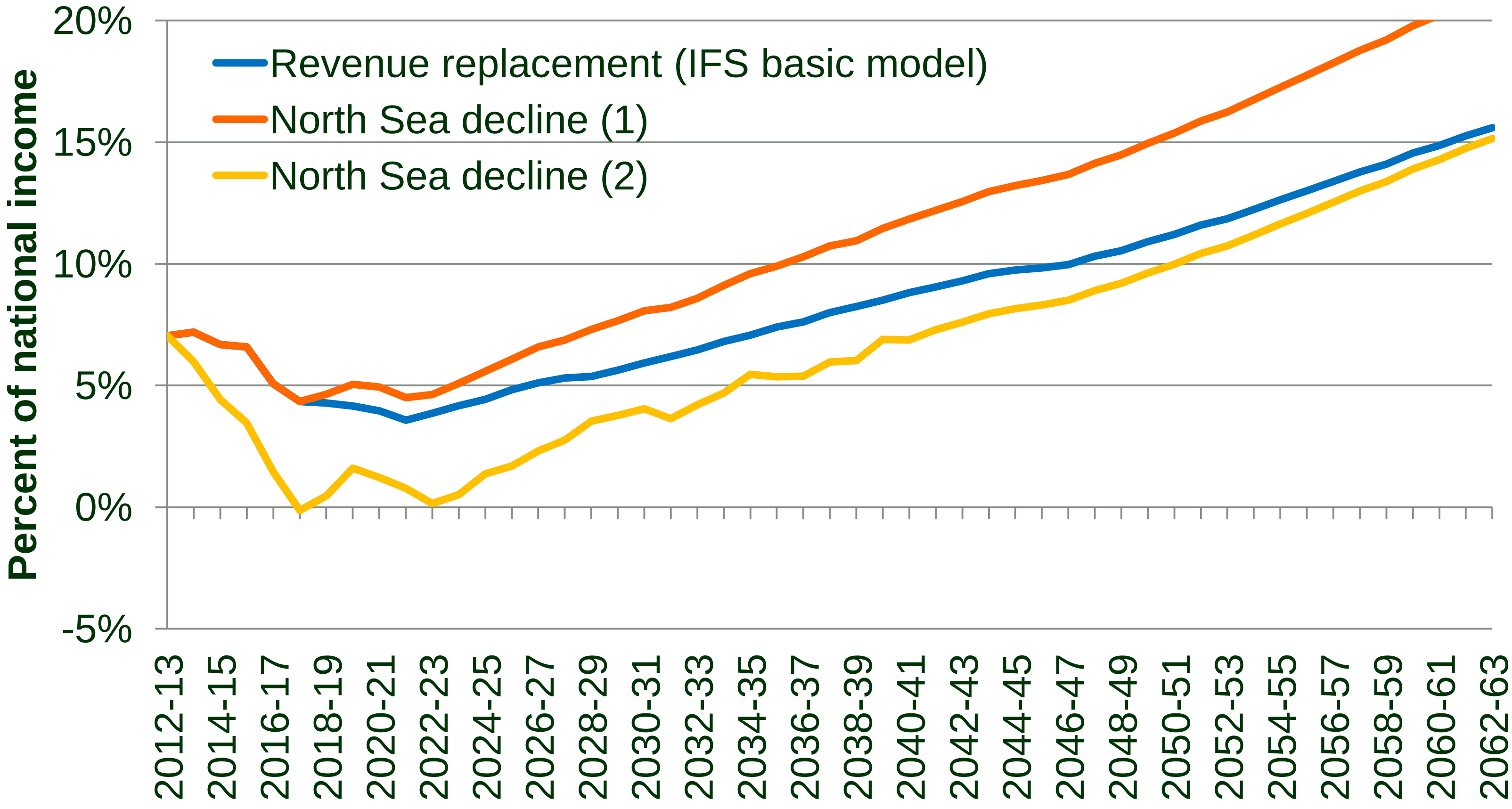
Alternative scenarios: North Sea revenues
Public sector net borrowing



Source: Amior, Crawford and Tetlow (2013a), Figure 3.6.

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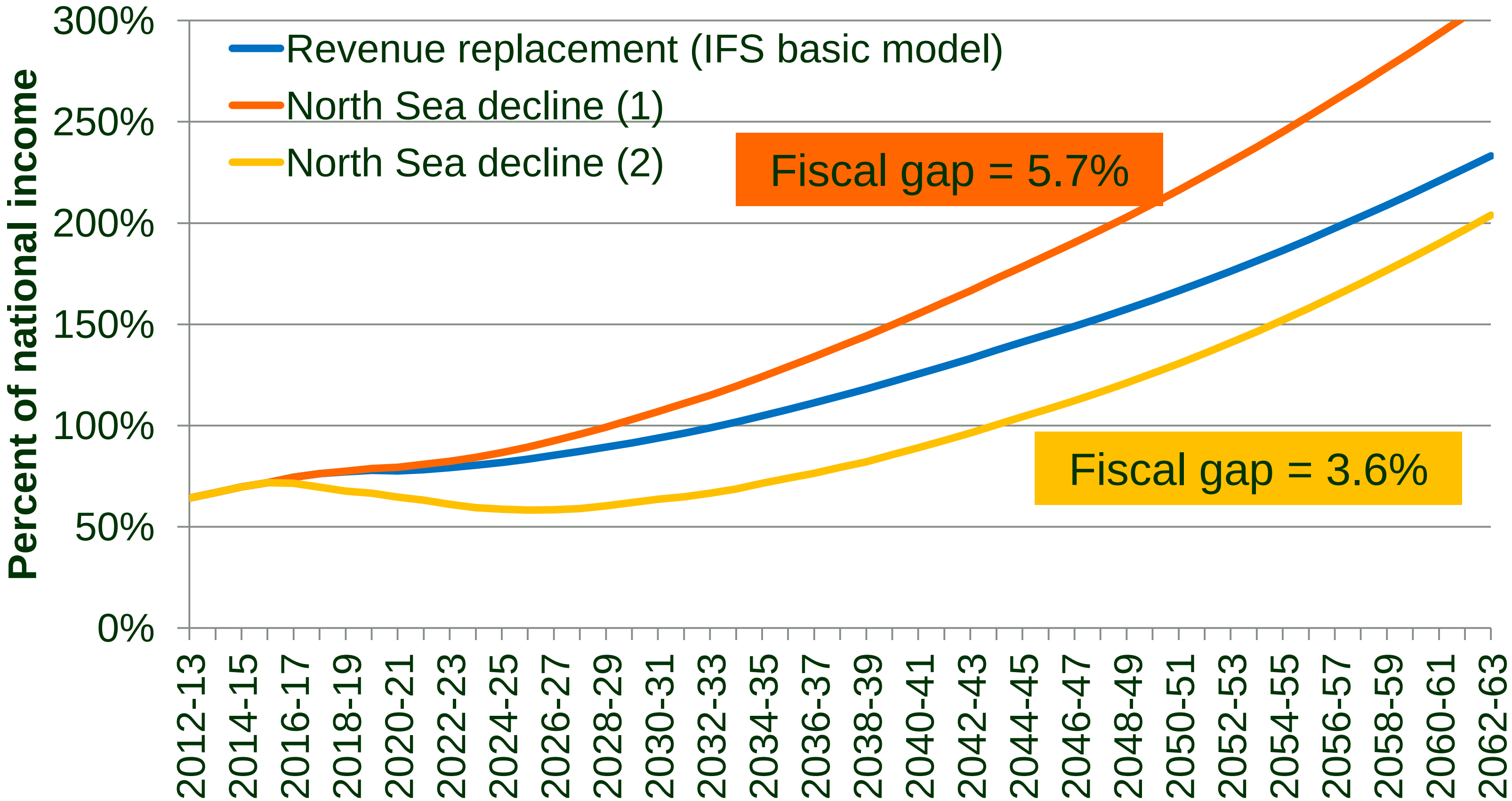
Alternative scenarios: North Sea revenues
Public sector net debt



Source: Amior, Crawford and Tetlow (2013a), Figure 3.7.

Productivity growth

- Basic model: 2.2% a year growth in labour productivity
- Average productivity growth in Scotland could be lower than this
  - Declining output from North Sea
  - To maintain average growth of 2.2% requires onshore productivity to increase more rapidly
- Alternative scenario: ‘1.7% productivity’
  - Onshore economy experiences average productivity of 2.2%
  - North Sea output disappears entirely by 2062–63
  - Average productivity growth in Scotland would be 1.7% a year
- In the model, lower productivity growth...
  - Revenues and non-interest spending grow less quickly in real terms, but amount to same share of national income as in basic model
  - But accumulated debt becomes more burdensome to service

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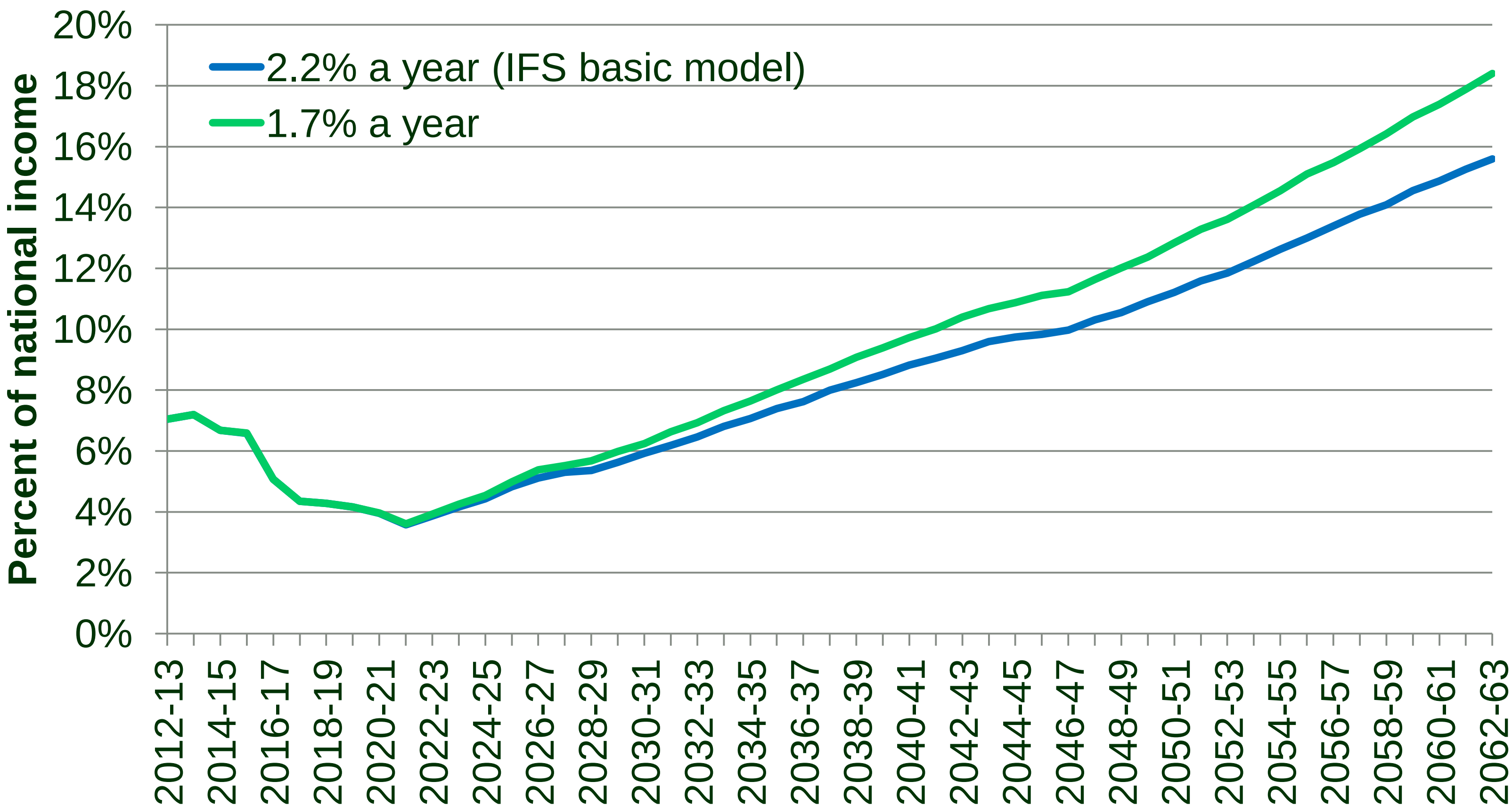
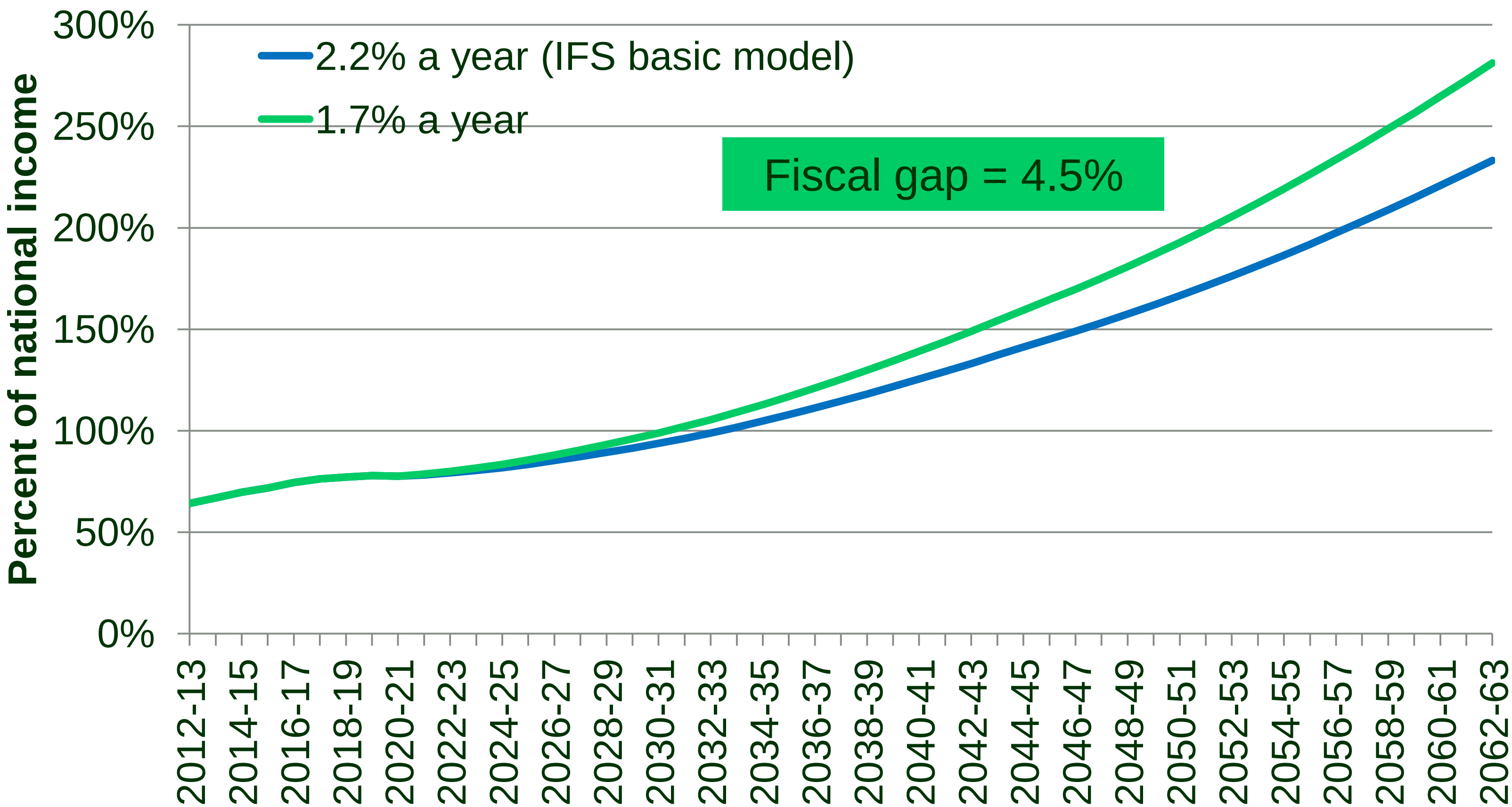
Alternative scenarios: productivity growth
Public sector net borrowing



Source: Amior, Crawford and Tetlow (2013a), Figure 3.3.

Alternative scenarios: productivity growth
Public sector net debt



Source: Amior, Crawford and Tetlow (2013a), Figure 3.4.

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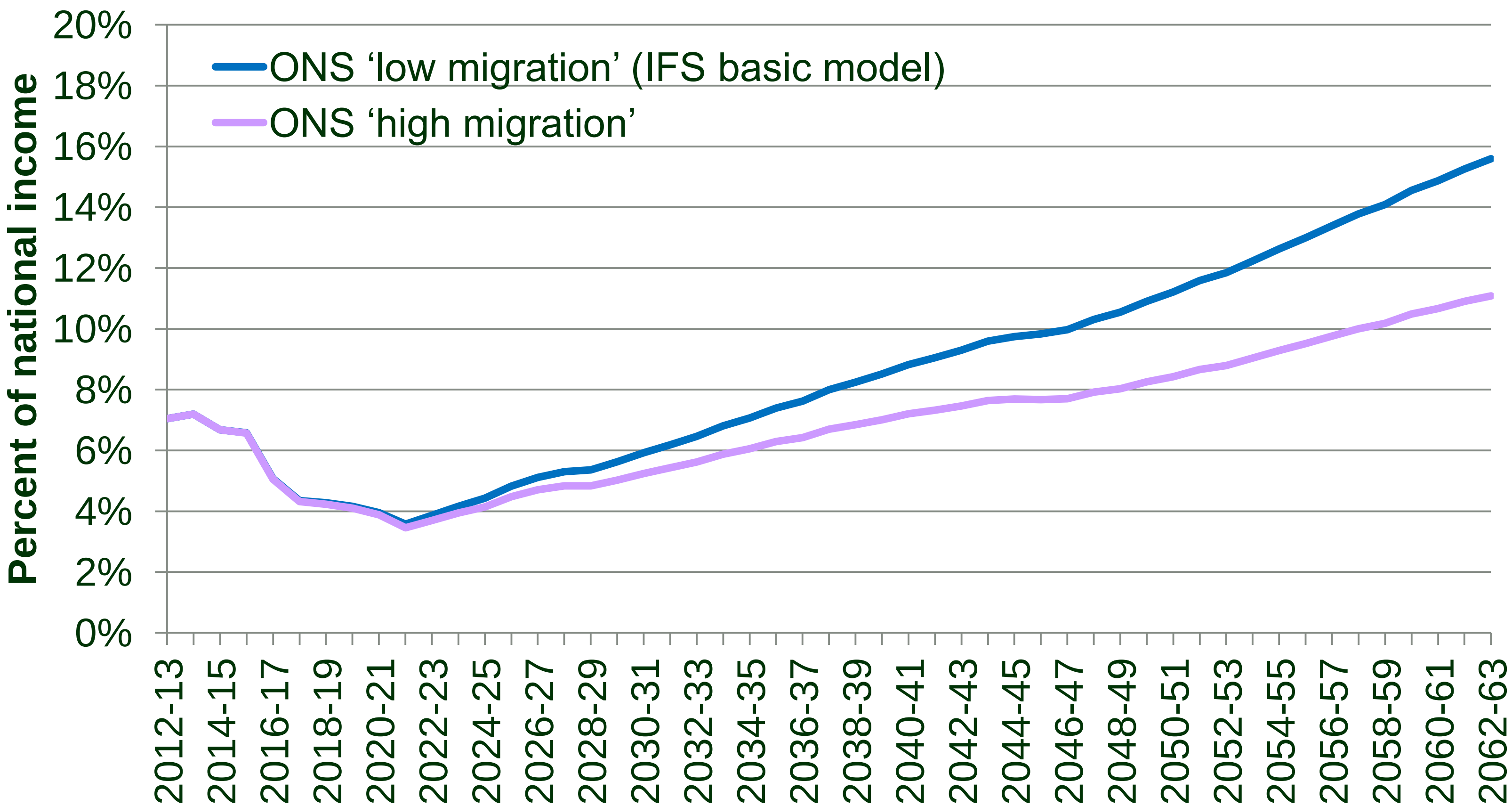
Migration

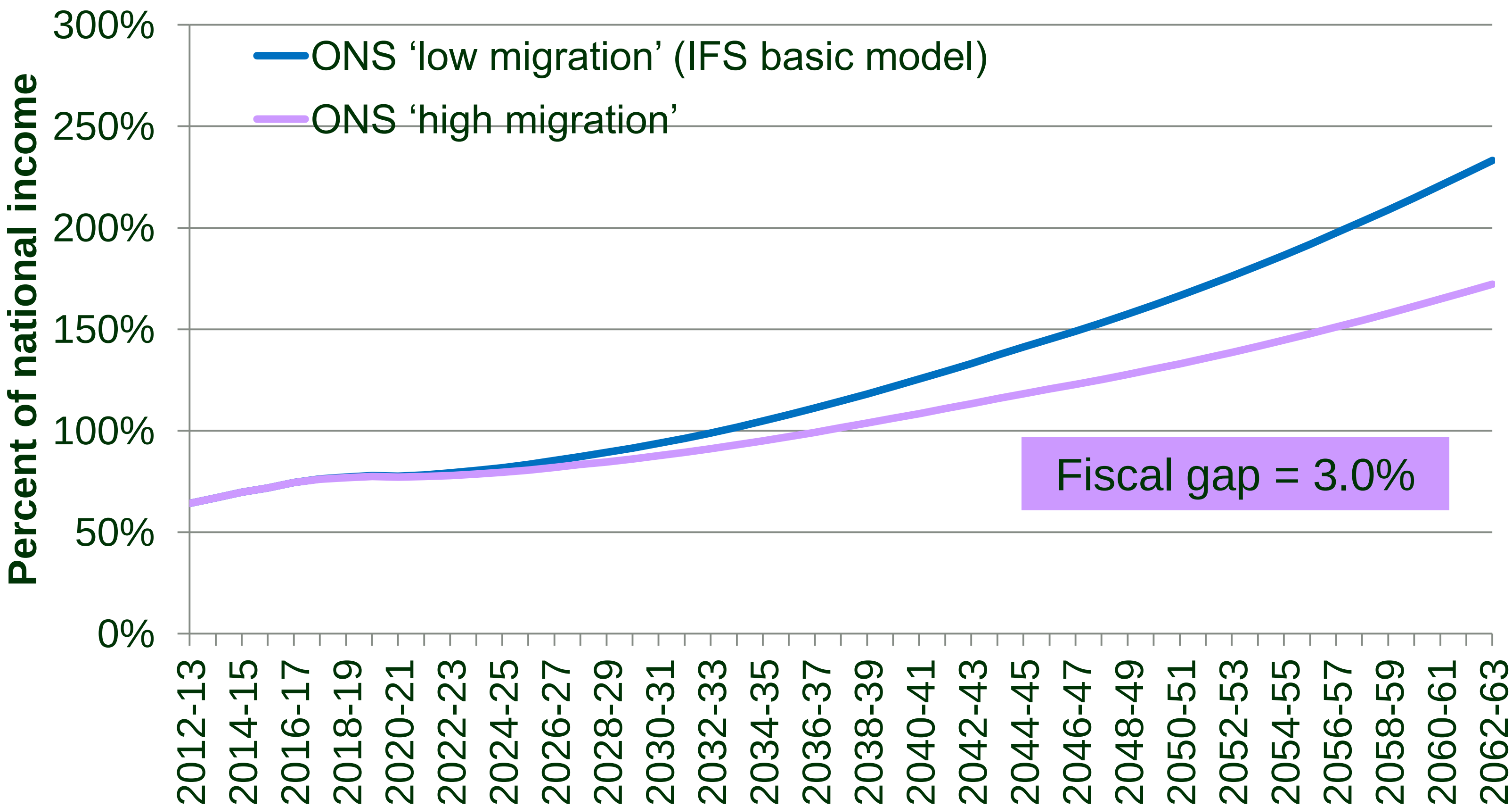
- Basic model: ONS ‘low migration’ projection
  - Net inward migration averaging 9,000 per year
- Migration to an independent Scotland could be higher than this
  - Independent Scottish government might pursue more liberal immigration policy than currently being pursued by UK government
- Alternative scenario: ‘high migration’
  - ONS ‘high migration’ projection
  - Net inward migration averaging 26,000 a year
- In the model, greater inward migration...
  - Migrant population on average younger than existing Scottish population
  - Increases tax revenues
  - Increases public spending but less than revenue increase
  - Borrowing and debt rise less rapidly

Alternative scenarios: migration
Public sector net borrowing



Source: Amior, Crawford and Tetlow (2013a), Figure 3.1.

Alternative scenarios: migration
Public sector net debt



Source: Amior, Crawford and Tetlow (2013a), Figure 3.2.

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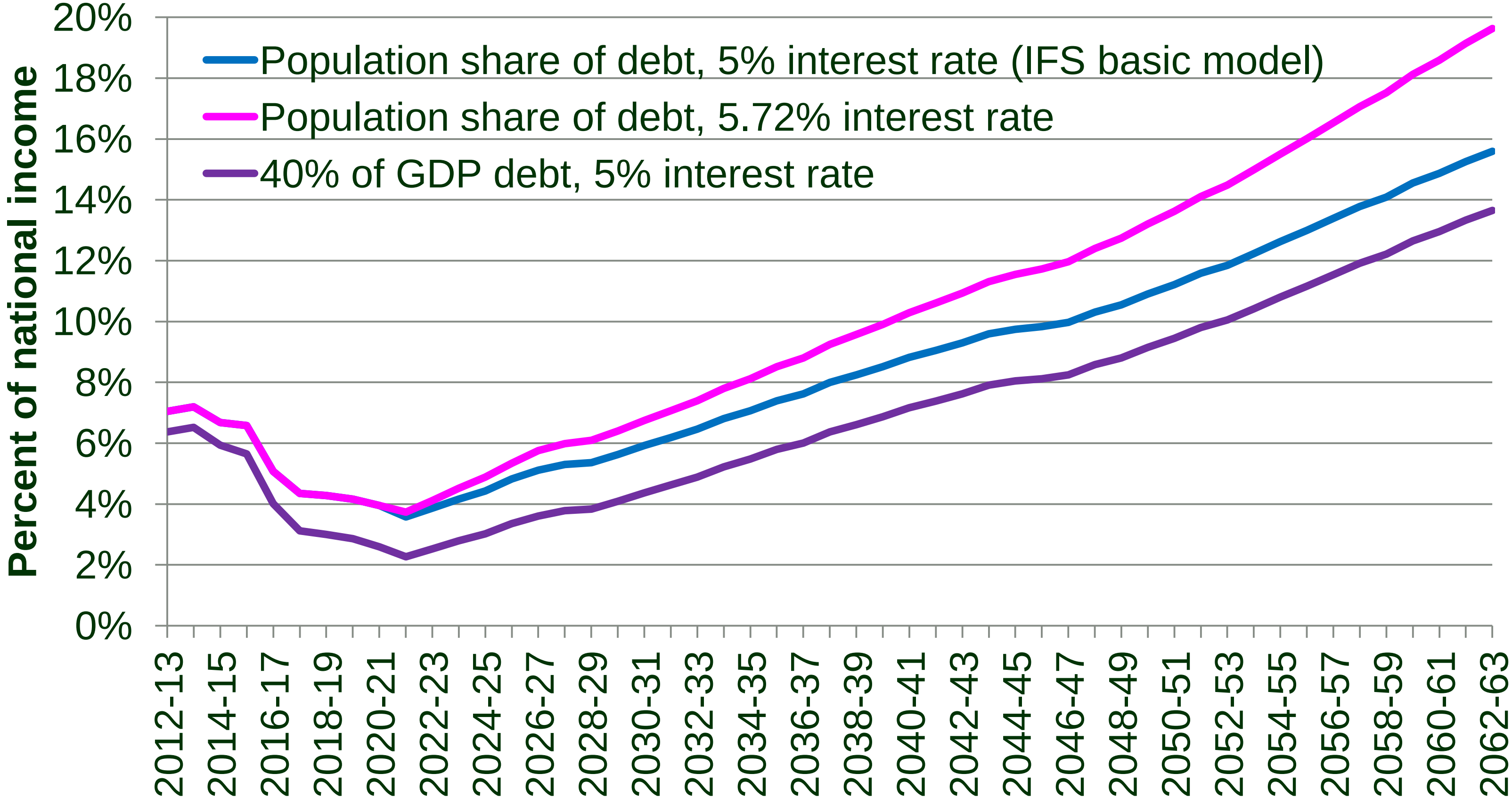
Debt level and interest rate

- Basic model:
  - Population share of debt
  - 5% interest rate from 2026–27
- Scotland could inherit a different share of accumulated debt
- Scotland might face a higher interest rate
  - Small economy with no track record on fiscal management
  - What currency would Scotland adopt? What currency would debt be denominated in?
- Alternative scenario: ‘40% debt, 5% interest rate’
  - Illustrative figure: approximately pre-crisis level of UK debt
- Alternative scenario: ‘Population share of debt, 5.72% interest rate’
  - Armstrong and Ebell (2013) estimate that Scottish interest rate would be 0.72 to 1.65 percentage points above UK rate

Alternative scenarios: debt level and interest rate

Public sector net borrowing



Source: Amior, Crawford and Tetlow (2013a), Figure 3.8.

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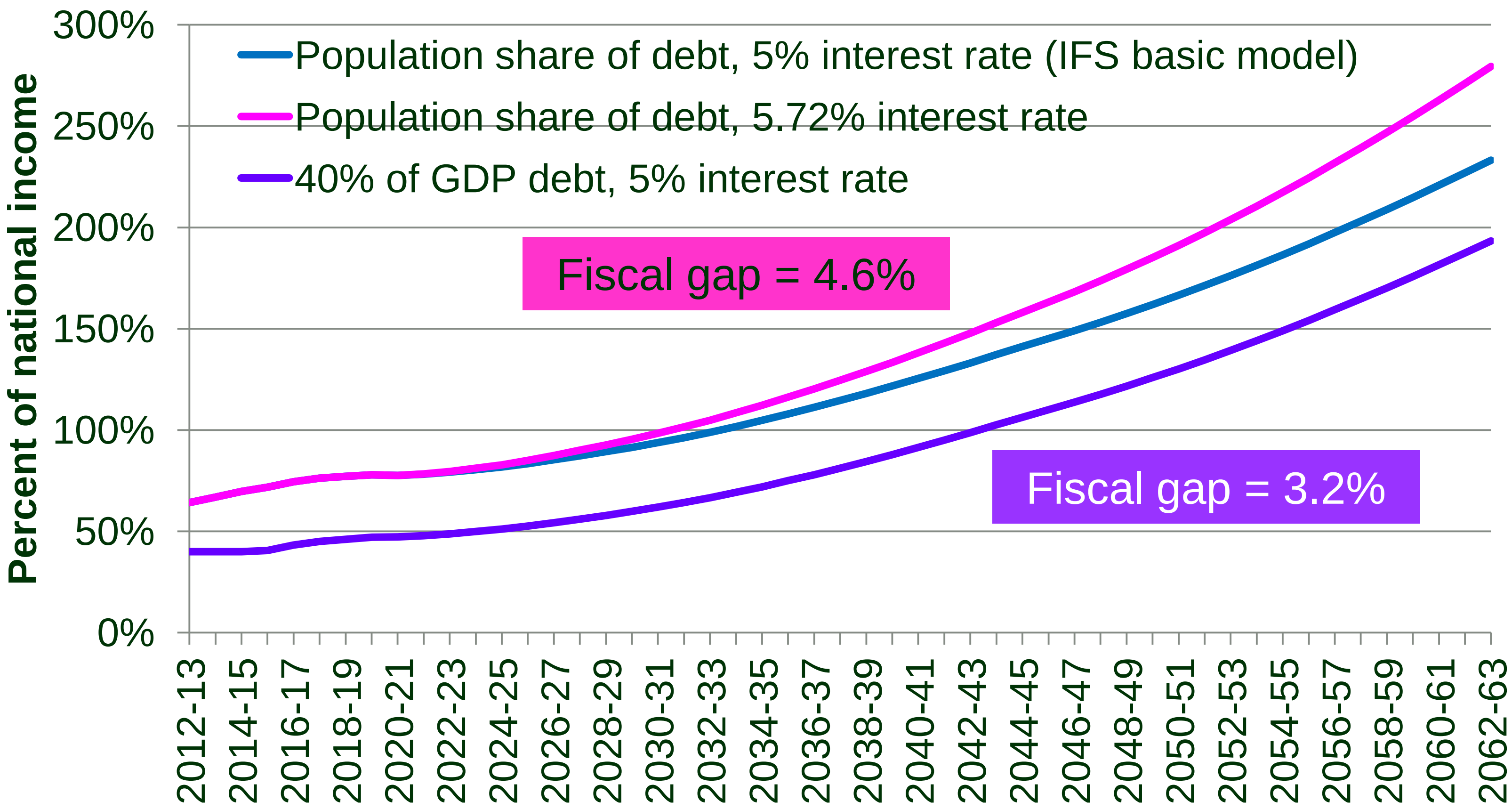
Alternative scenarios: debt level and interest rate
Public sector net debt



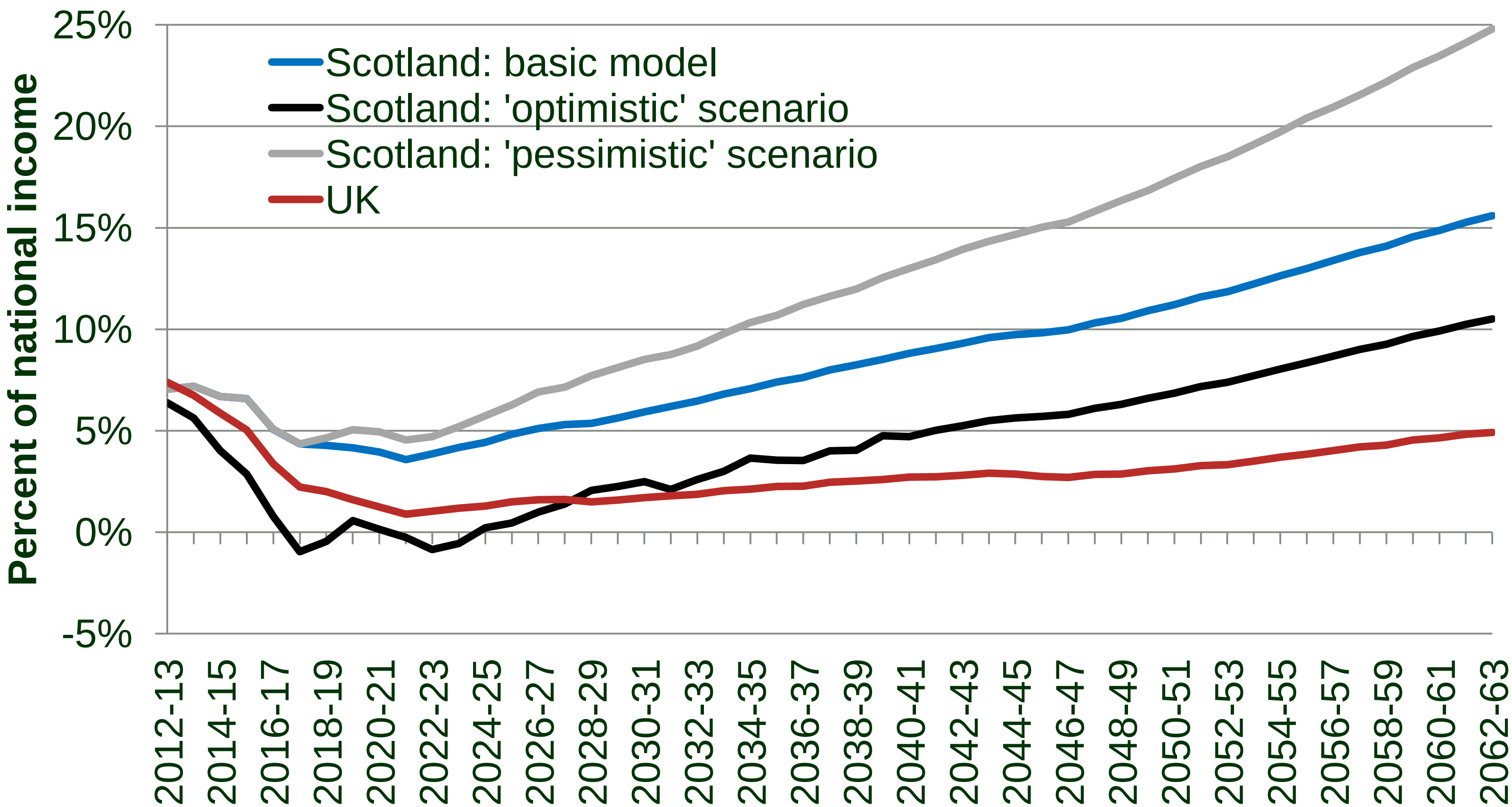
Source: Amior, Crawford and Tetlow (2013a), Figure 3.9.

Composite scenarios

- ‘Optimistic’ scenario
  – 40% debt
  – ‘high migration’
  – North Sea decline (2)

- ‘Pessimistic’ scenario
  – Population share of debt
  – 1.7% productivity growth
  – North Sea decline (1)
  – (But still assume 5% interest rate on debt)

Composite scenarios
Public sector net borrowing



Source: Authors' calculations and Figure 4.1 of Amior, Crawford and Tetlow (2013a).

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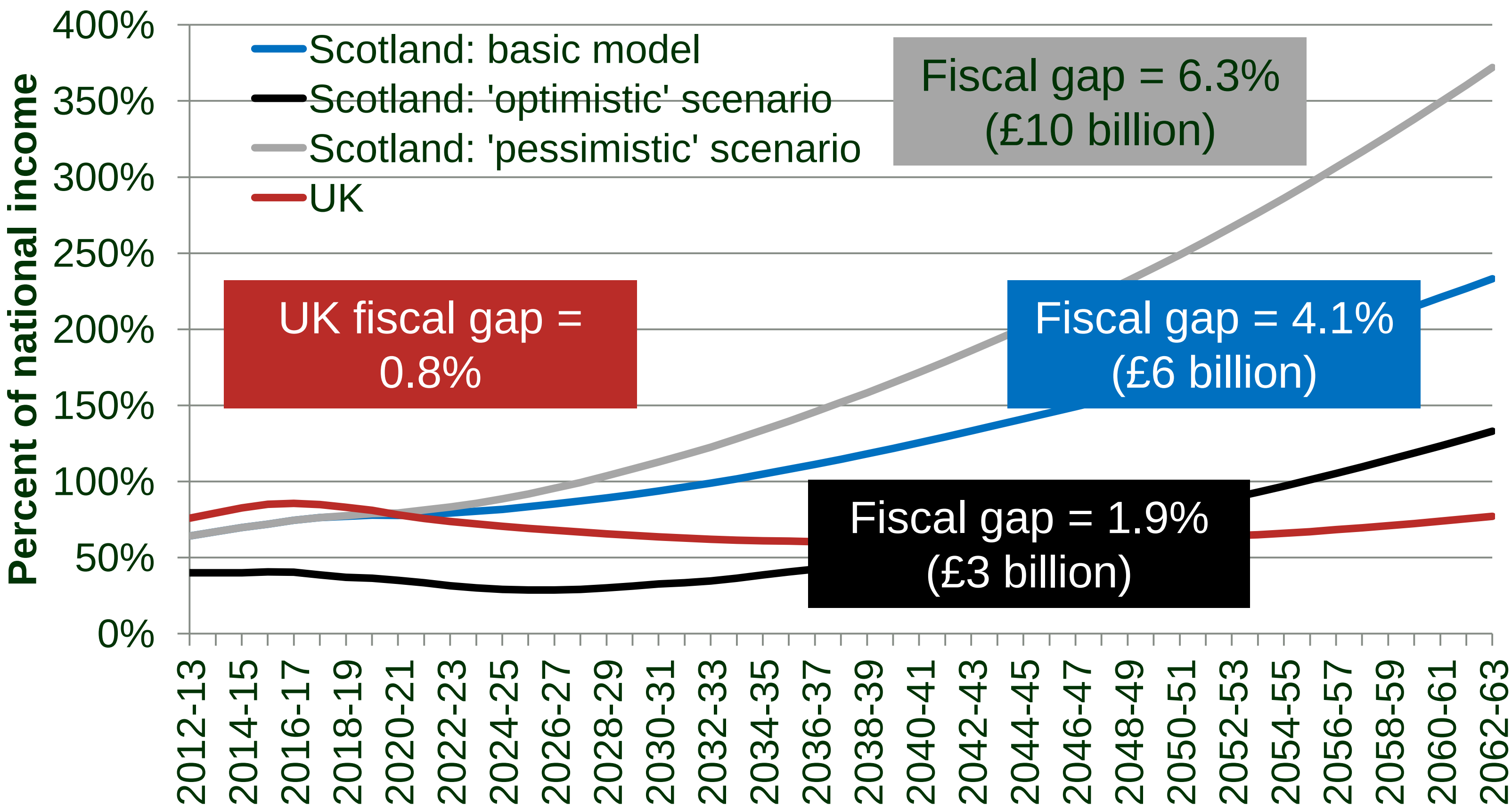
Composite scenarios
Public sector net debt



Source: Authors’ calculations and Figure 4.2 of Amior, Crawford and Tetlow (2013a).

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Closing the fiscal gap in Scotland?

- Tax increases and/or spending cuts required
- Revenue yield from example tax increases (in 2014–15)
  - +1ppt on main rate of VAT = £430 million
  - +1ppt on basic rate of income tax = £365 million
- Indicative scale of spending squeeze required
  - £3 billion would equate to 6% of total non-interest spending, or 8% of public service spending
- Policies mooted by current Scottish government
  - Increase spending: higher aid spending, delay or scrap planned rise in state pension age, reverse cuts to housing benefit
  - Reduce spending: cut defence spending

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Conclusions

- Independent Scotland would face unsustainably increasing levels of public sector debt over next 50 years unless further tax increases or spending cuts were announced
- Fiscal gap facing Scotland would be larger than for the UK
  - Larger gap between spending and revenues at baseline
  - More rapidly ageing population
  - Much more reliant on revenues from the North Sea, which are likely to decline over the longer-run
- This conclusion is robust to a wide range of possible assumptions
- Long-run fiscal pressures should form important backdrop to any discussions about changes to tax/spending policies of independent Scotland
  - Independent Scotland can achieve fiscal sustainability but would need to make some difficult decisions