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Fiscal sustainability of an independent Scotland

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E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

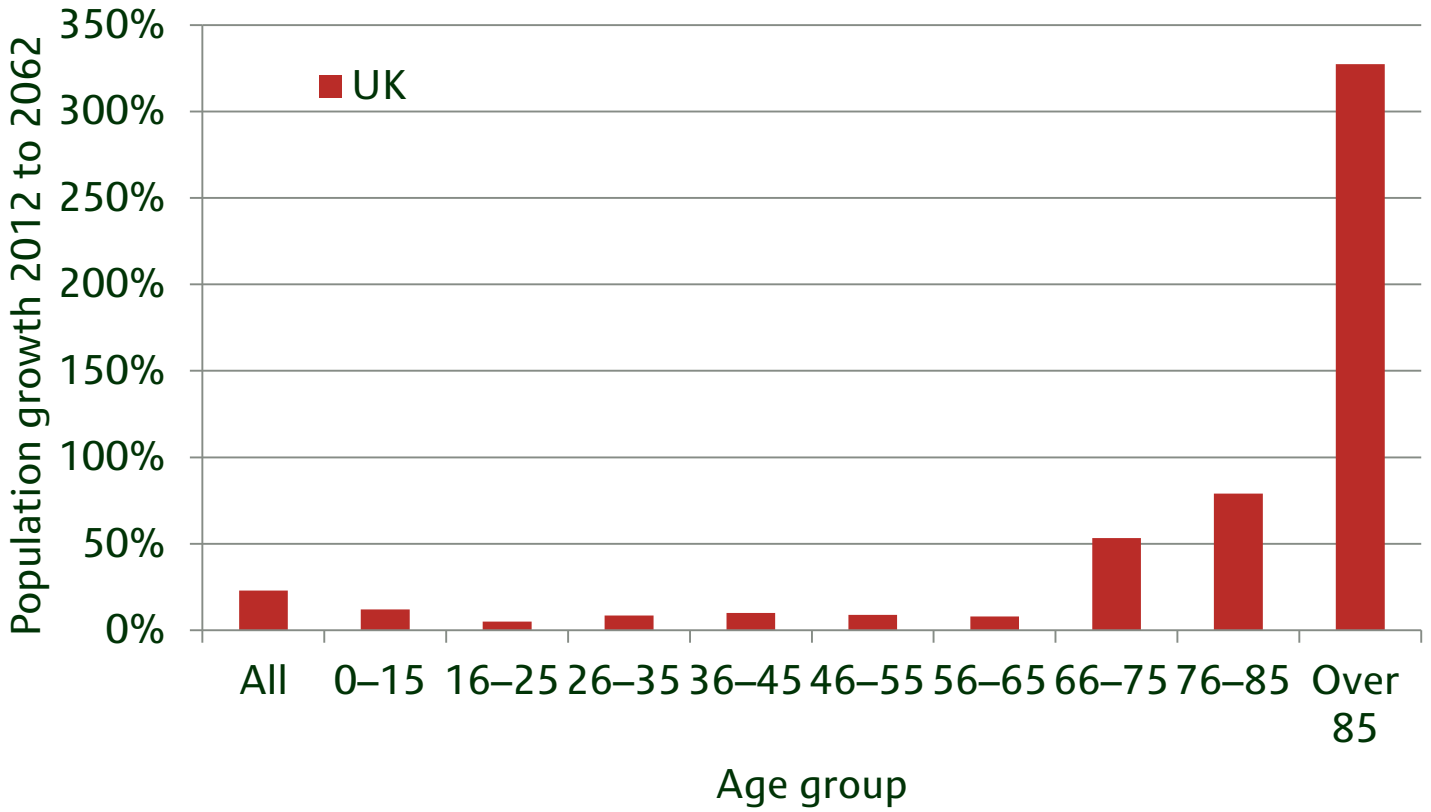
FUTURE OF THE UK AND SCOTLAND

Introduction

- Assessment of the long-run outlook for the UK public finances produced annually by the Office for Budget Responsibility (OBR)
  - *Fiscal Sustainability Report (FSR)*
- An important issue because demographic changes are putting pressure on the public finances

UK has an ageing population
ONS projections for demographic change 2012 to 2062

- UK population expected to age (increase median age 39 to 43)



Note: Based on ONS 'low migration' variant 2010-based projections

Source: Amior, Crawford and Tetlow (2013a), Table 2.3

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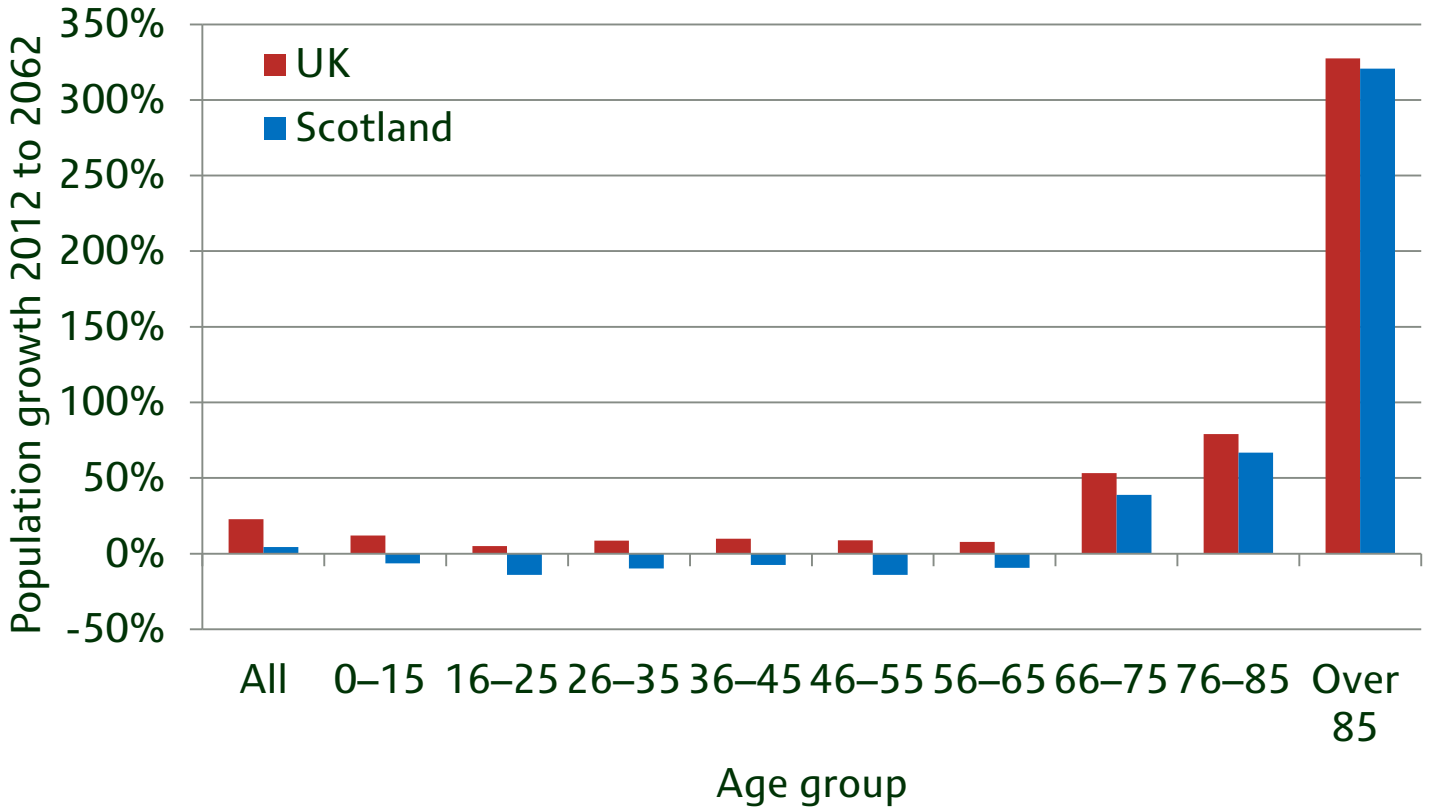
  - Ageing population tends to increase demand for spending on certain areas (notably health and pensions)
- IFS research published today investigates the fiscal pressures that would face an independent Scotland

Scotland also has an ageing population
ONS projections for demographic change 2012 to 2062

- Scottish population projected to increase more slowly and age more rapidly than the UK as a whole (median age from 40 to 46)



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- IFS research published today investigates the fiscal pressures that would face an independent Scotland
  - Constructed a long-run public finances model that is very similar to that used by the OBR for their FSR
  - Focus on the question: How does the long-run fiscal outlook for Scotland differ from that of the UK?

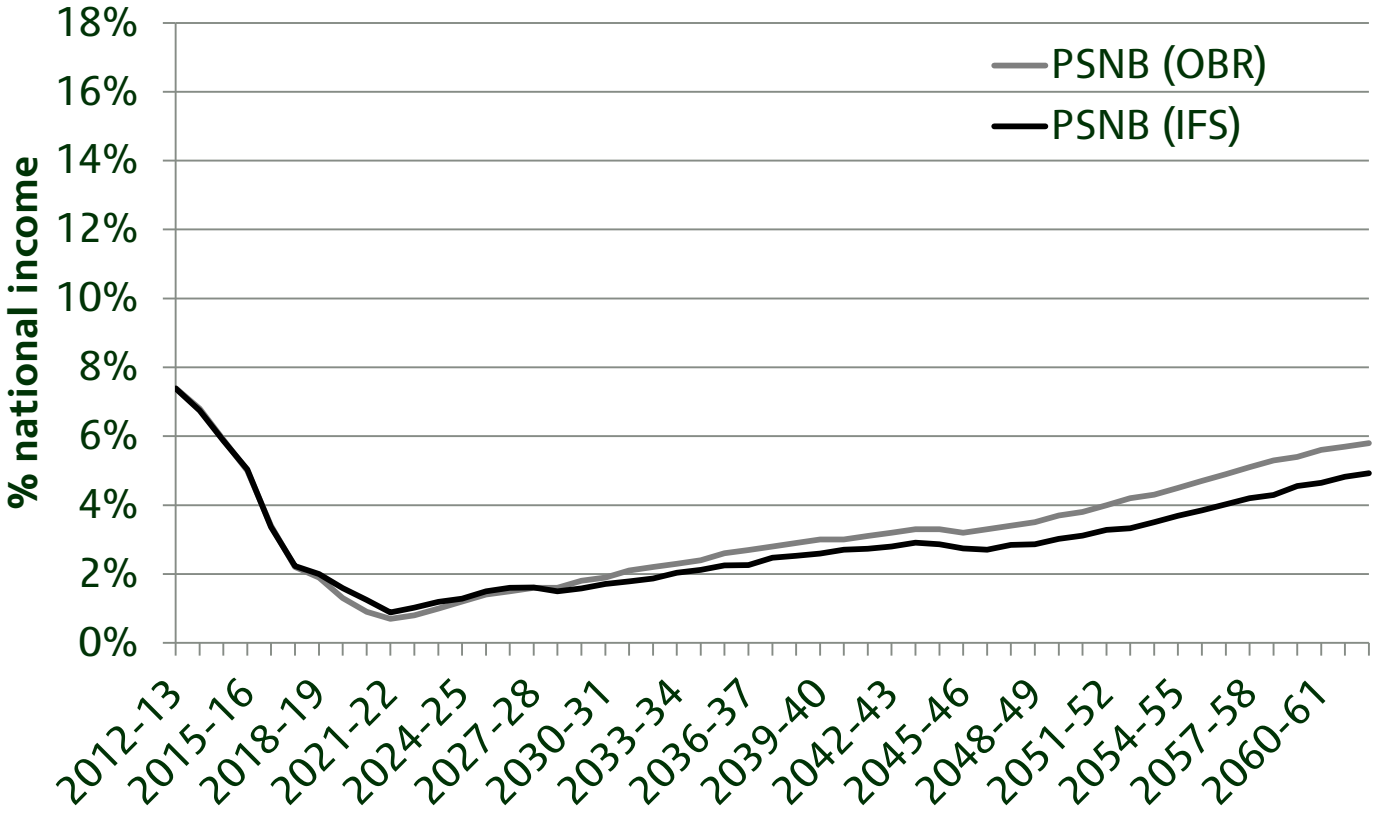
The IFS long-run public finance model

- Seeks to answer questions of the type:

  "*What would be the fiscal consequences of continuing into the future with our current set of tax and spending policies?*"
- Project public finance position for the next 50 years on the basis of "unchanged policy"
  - Incorporate all announced fiscal consolidation up to 2017-18
  - Incorporate cyclical recovery up to 2021-22
  - Assume benefit rates and tax thresholds increase in the longer run in line with average earnings (rather than price inflation, as is commonly legislated)
- Main driver of change is therefore changing demographics
- Can also be incorporate other fiscal trends (e.g. state pension age increase, decline in North Sea revenues)

Example output:
IFS projections for the UK compared to OBR

- Projections for public sector net borrowing:



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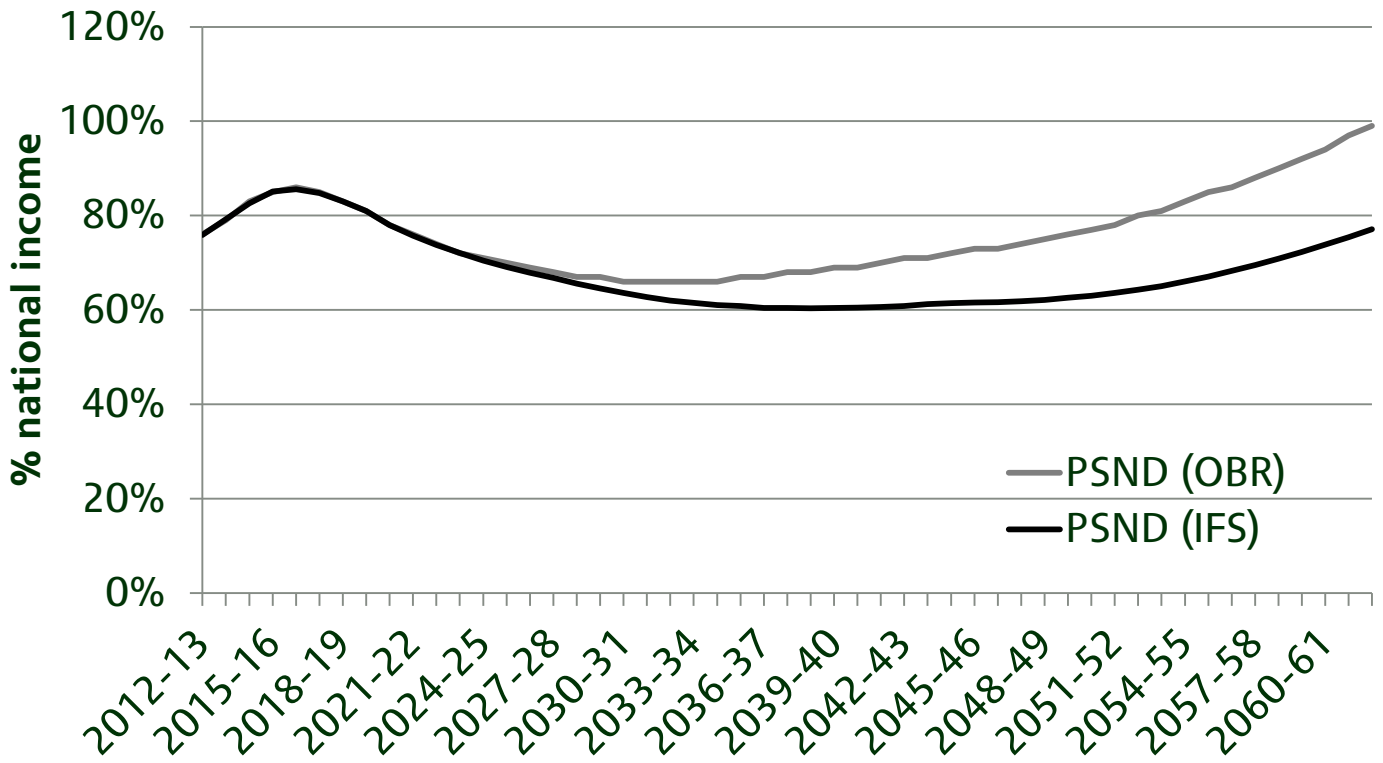

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IFS projections for the UK compared to the OBR

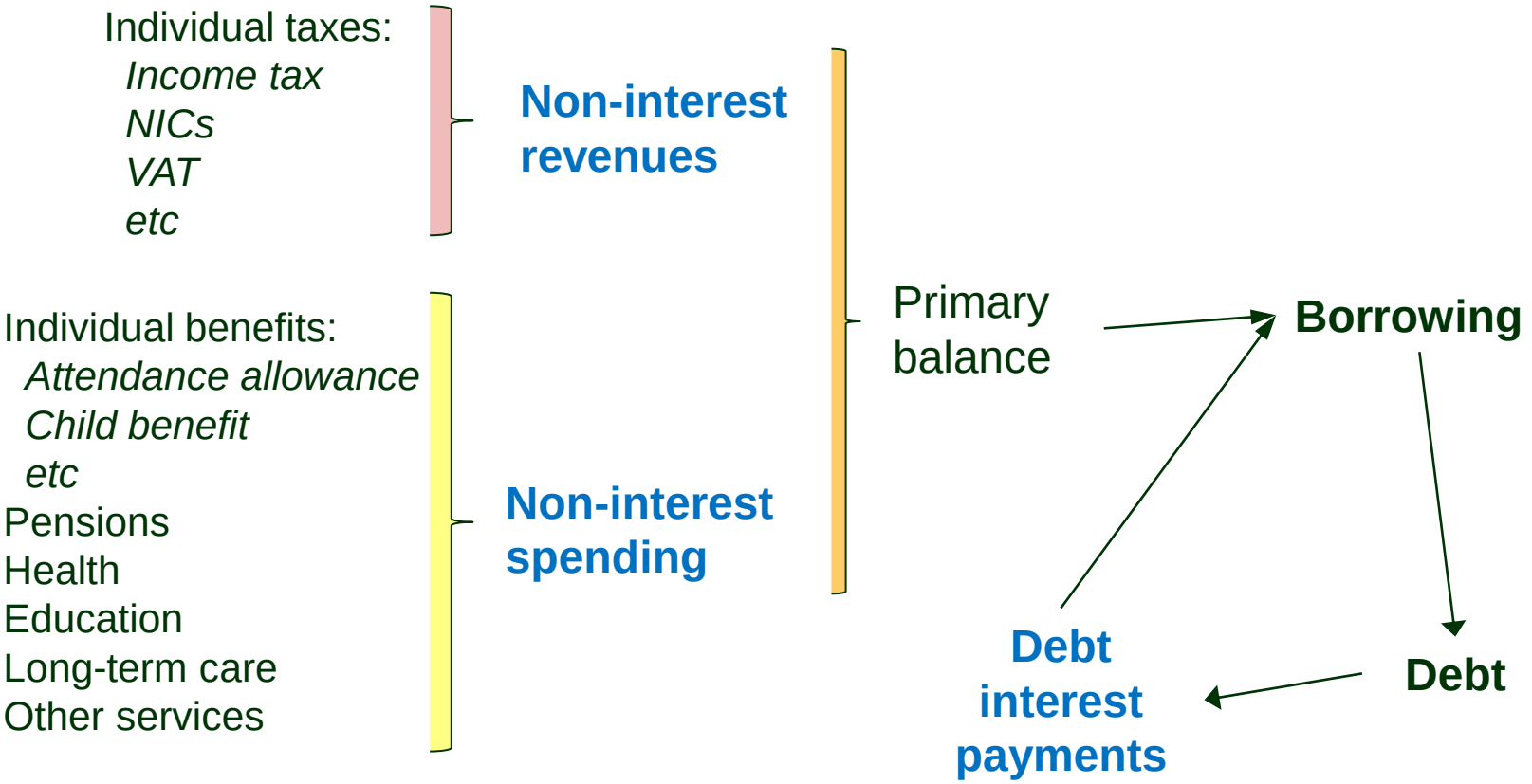
- IFS model slightly more optimistic for the UK (projects lower borrowing and lower debt in the long run) than the OBR
- More detail comparing the underlying differences between our model and the OBR's available in the online working paper
- Main focus of this work is on how the outlook for Scotland might differ to that for the UK

Presentation outline

- Brief overview of how the IFS long-run public finances model works
  - More detail available in the report and online working paper
- Describe the projections for Scotland of the "basic" model
  - Essentially taking the OBR's assumptions for the UK as a whole and applying them to Scotland

- Next presentation will:
  - Discuss the sensitivity of these projections to the underlying assumptions
  - Illustrate some alternative projections for Scotland

Basic structure of the model



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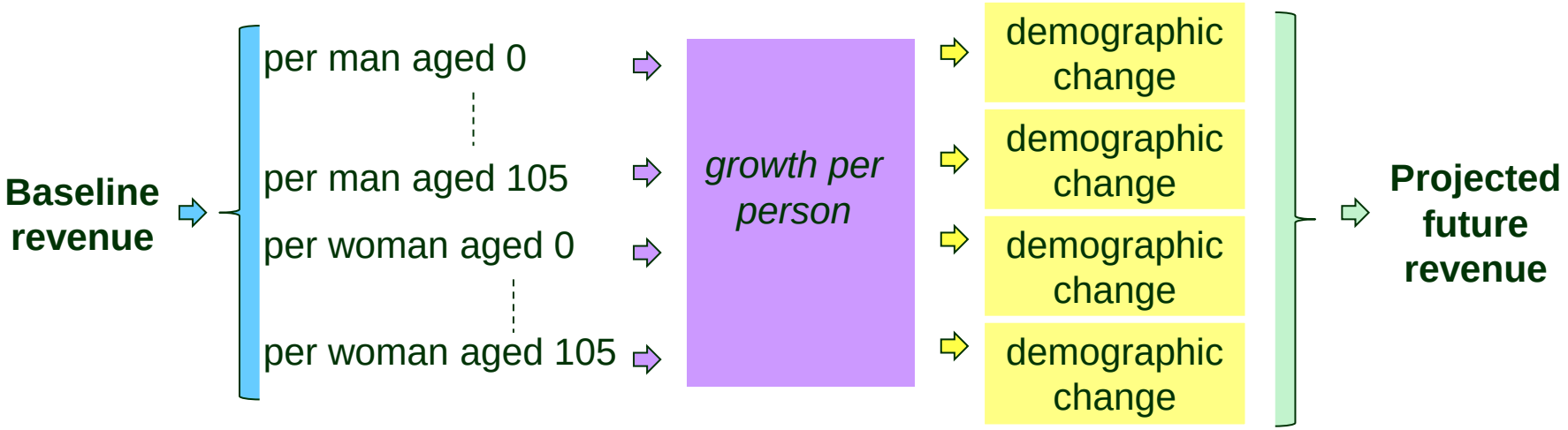
Basic structure of the model
-> Non-interest revenues

- Revenue from each tax projected using the following process:



- We can incorporate alternative external projections for future revenues from a given tax
  - Only done this for North Sea revenues

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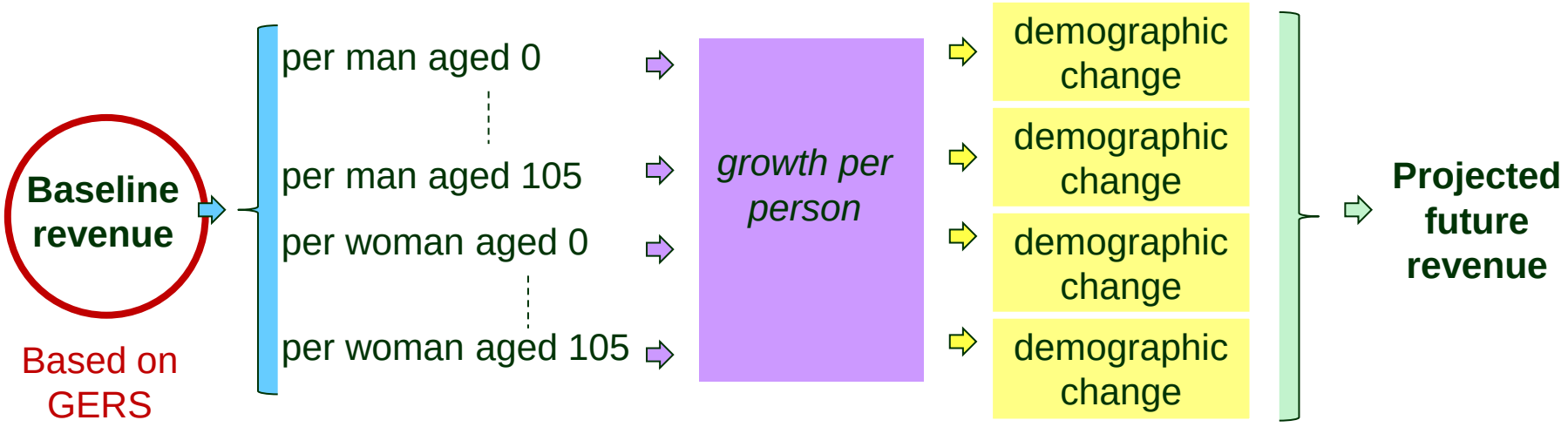

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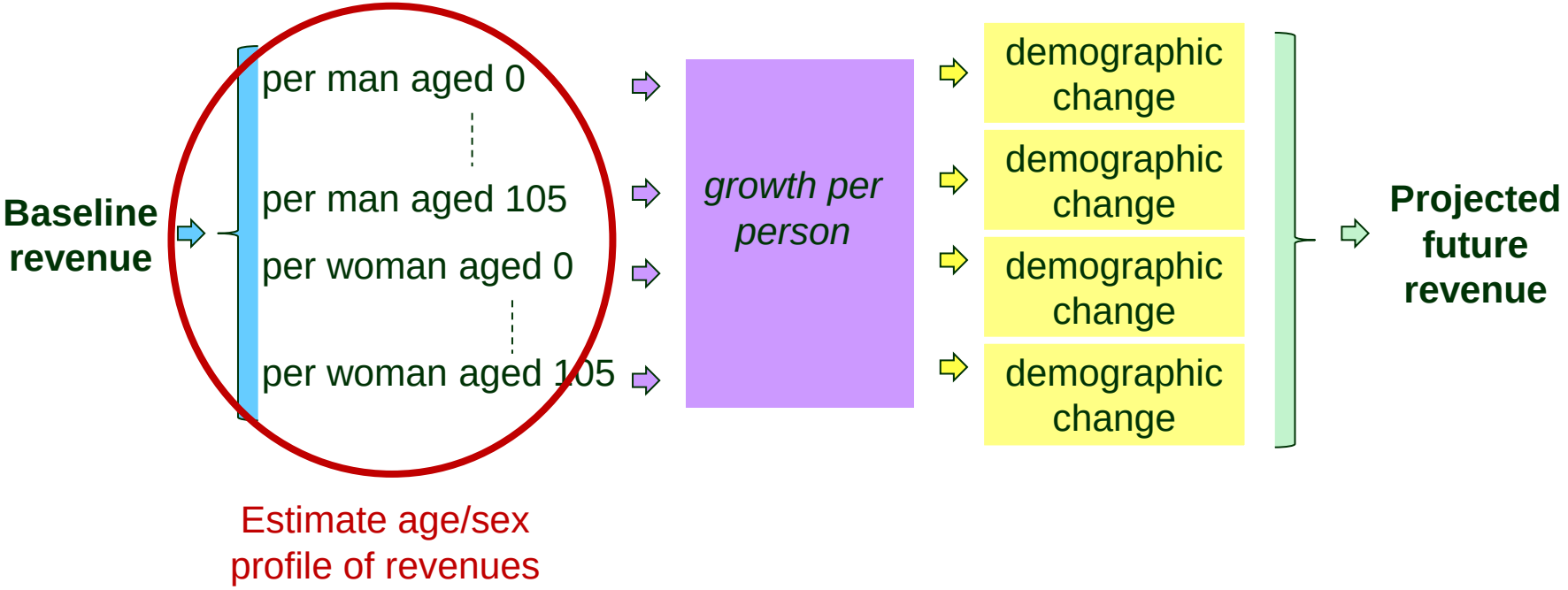
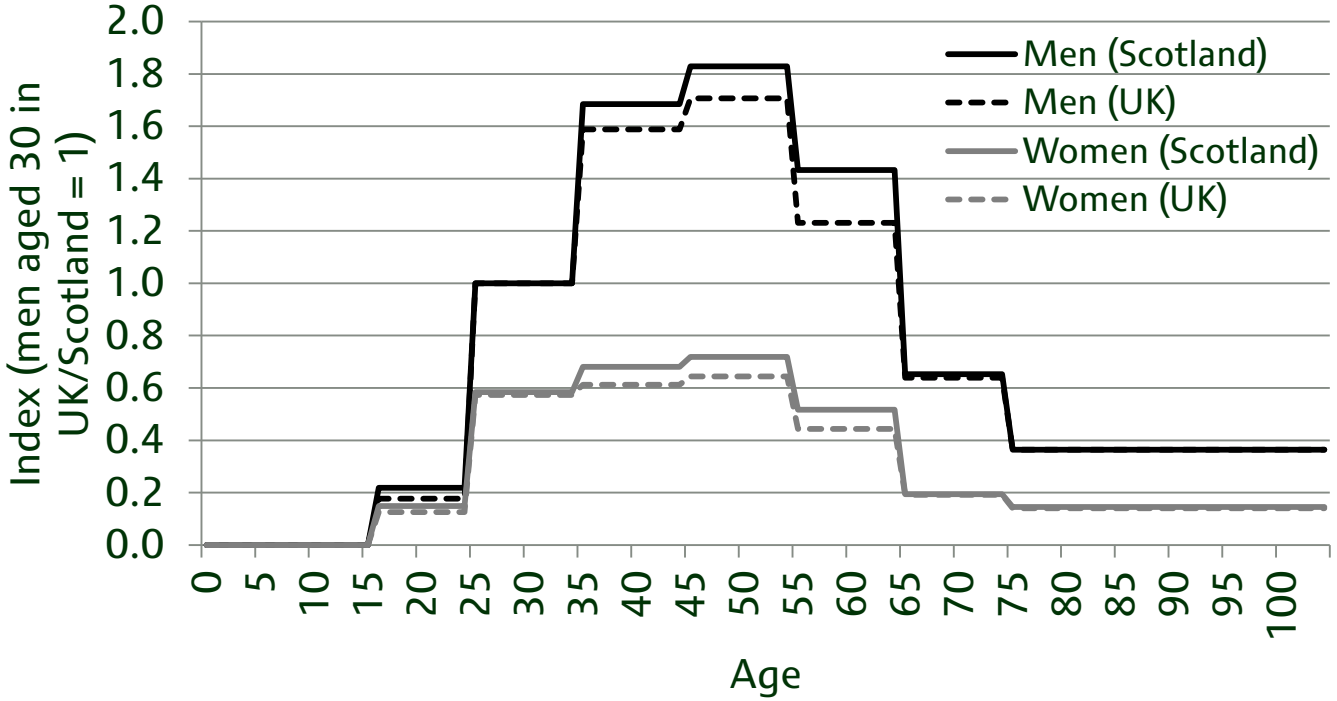


Age-sex profiles of revenues

- Estimate for each tax how much is raised from each individual of a given age and sex
- For example: Income tax
  - Data from the Survey of Personal Incomes



Source: Amior, Crawford and Tetlow (2013a), Figure 2.2

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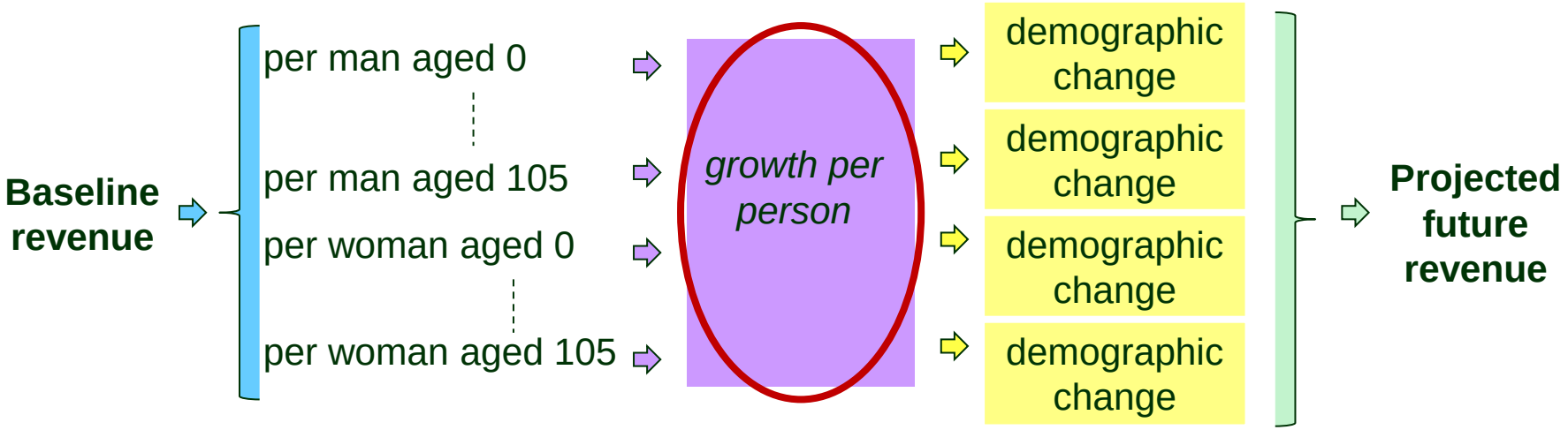

Mostly assumed to grow in line with average earnings
(product of labour **productivity growth** and inflation)

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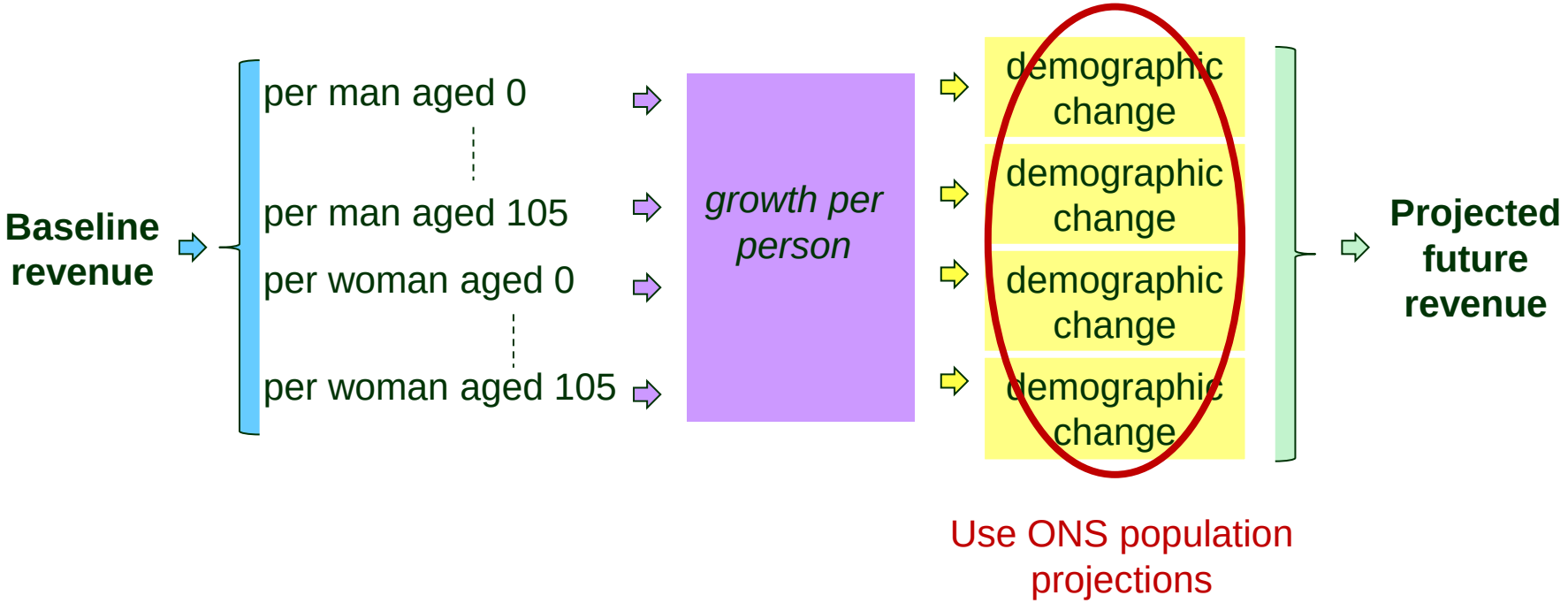
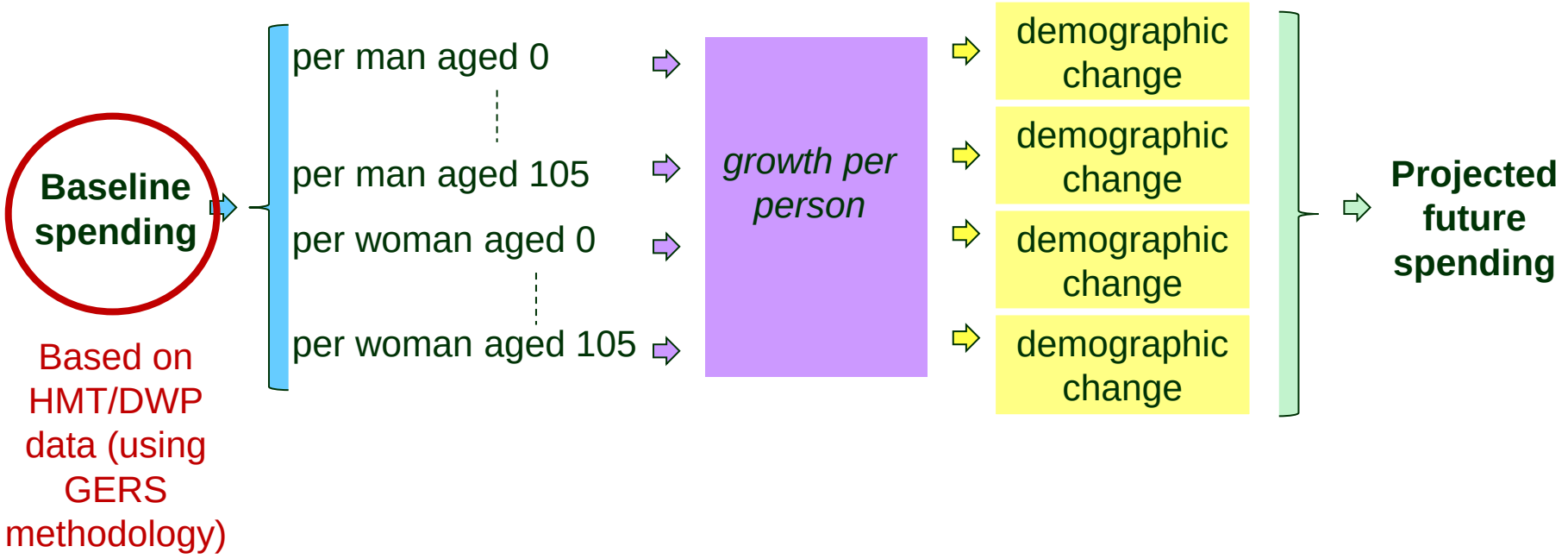


Basic structure of the model
-> Non-interest spending

- Project most areas of non-interest spending using the same method as for revenues:



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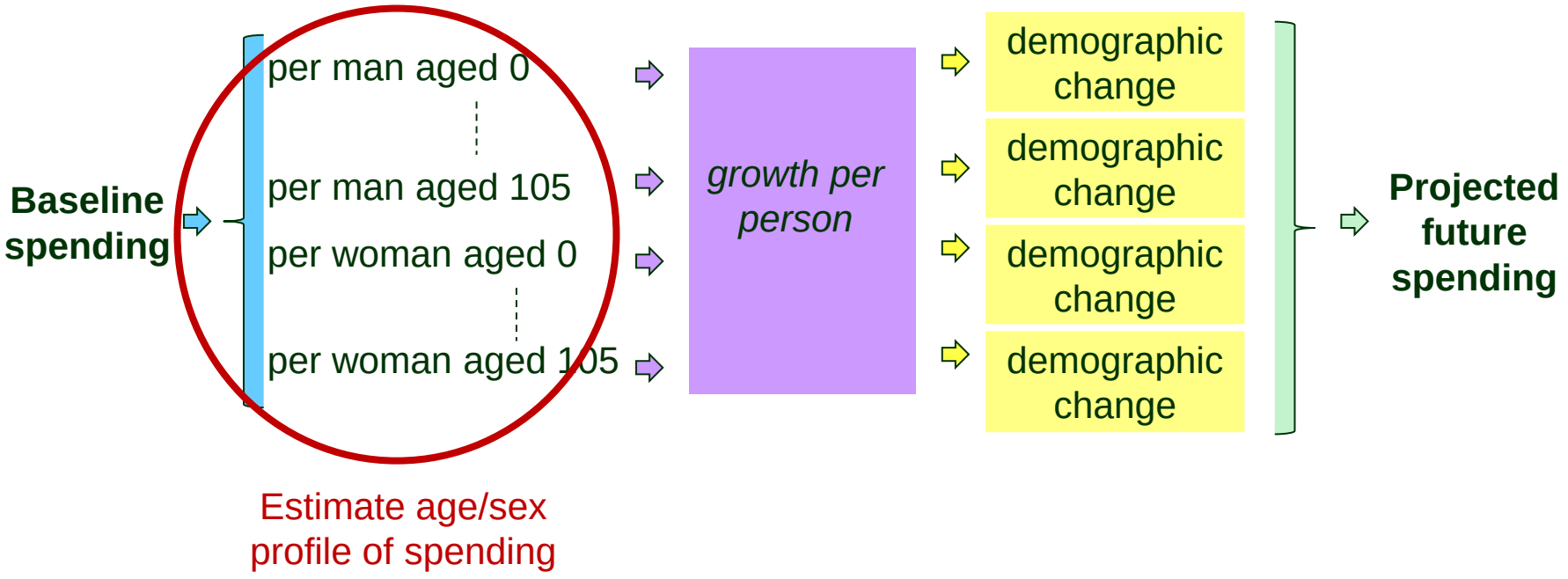
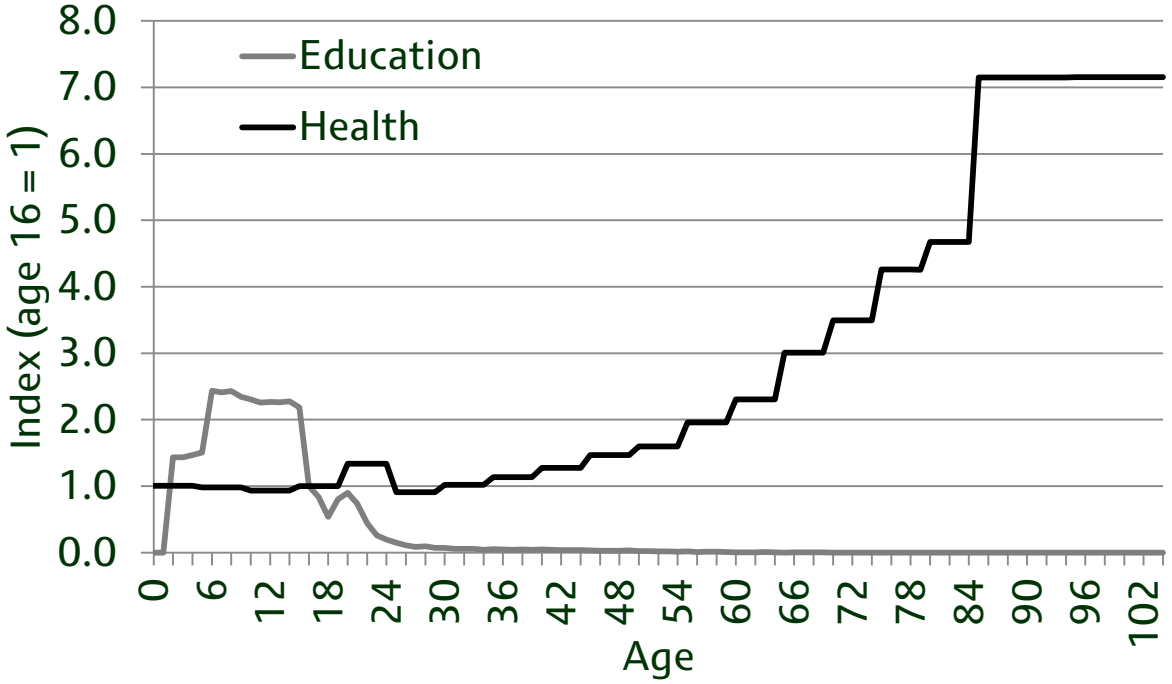


Age-sex profiles of spending

- Estimate for each area of spending how much is spent on each individual of a given age and sex
- For example: Health and education
  - Data from Department of Health, Labour Force Survey and Department for Education



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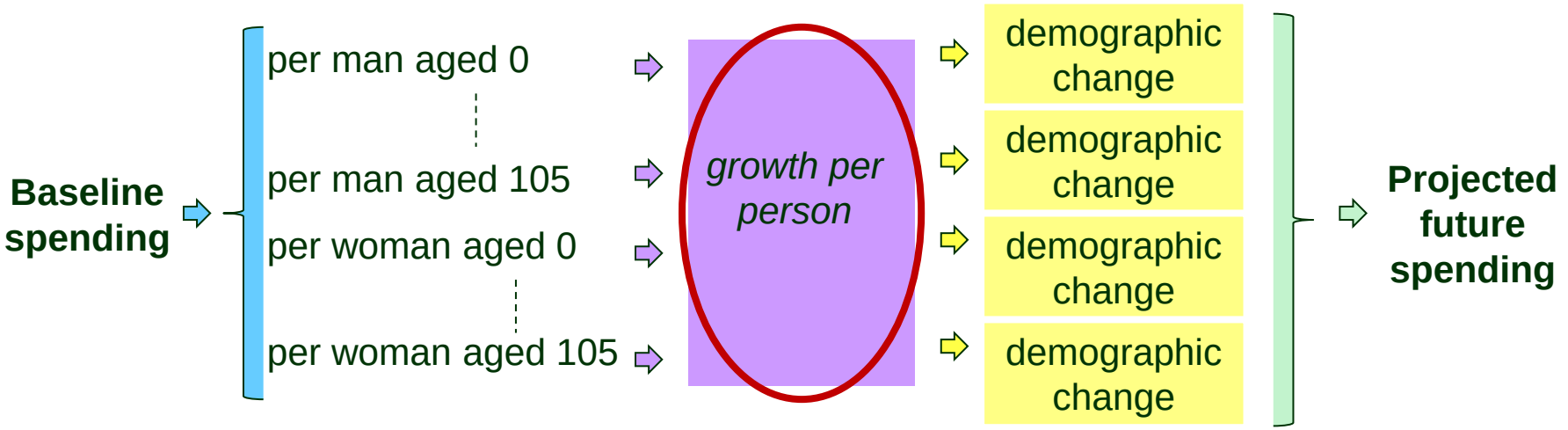

Health, education, social benefits: assumed to grow in line with average earnings
'Other non-interest spending': assumed to grow in line with nominal per capita national income

Basic structure of the model
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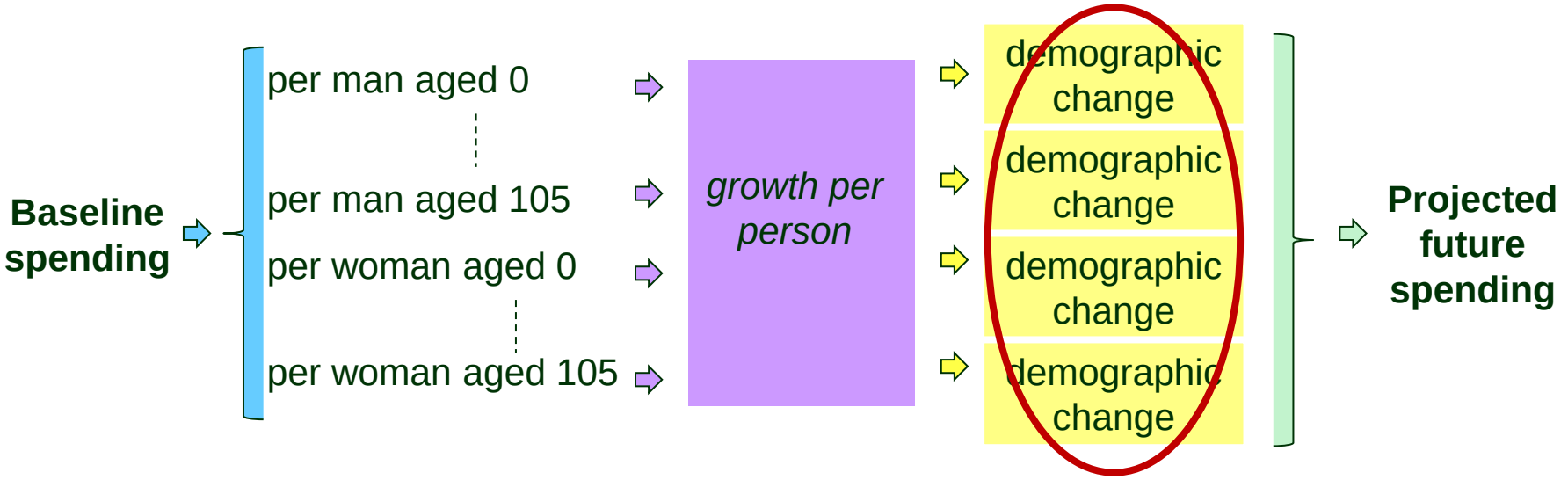
- Project most areas of non-interest spending using the same method as for revenues:



Basic structure of the model
-> Non-interest spending

- For some areas of spending, changes over time not only driven by demographic changes, but also by recent and historical changes in policy
  - Spending per age-sex head will differ across cohorts
  - Better to project spending in these areas in a different way
- OBR uses 'external forecasts' for projected UK spending on
  - state pensions (and other pensioner-specific benefits) <- DWP
  - public service pensions <- Government Actuary's Department
  - long-term care <- Personal Social Services Research Unit
- We use these external projections to project future spending in Scotland:
  - Estimate baseline share of spending between Scotland and rest of UK
  - Assume spending per head grows at the same rate in Scotland as in the rest of the UK

Basic structure of the model
-> Borrowing and debt

- Non-interest revenues and non-interest spending projected for the next 50 years
- **Primary balance** = non-interest revenues – non-interest spending
- **Borrowing** (PSNB) = – primary balance + net interest payments
  - Net interest payments depend on interest rate on government debt
- Borrowing adds to public sector net **debt** (PSND) over time
- Two things to bear in mind:
  - Small differences in borrowing in one year can lead to greater differences in borrowing the following year
    - higher borrowing results in higher debt, therefore next year: higher interest payments, higher overall spending and therefore higher borrowing
  - Small differences in annual borrowing can cumulate to large differences in public sector net debt over a long period

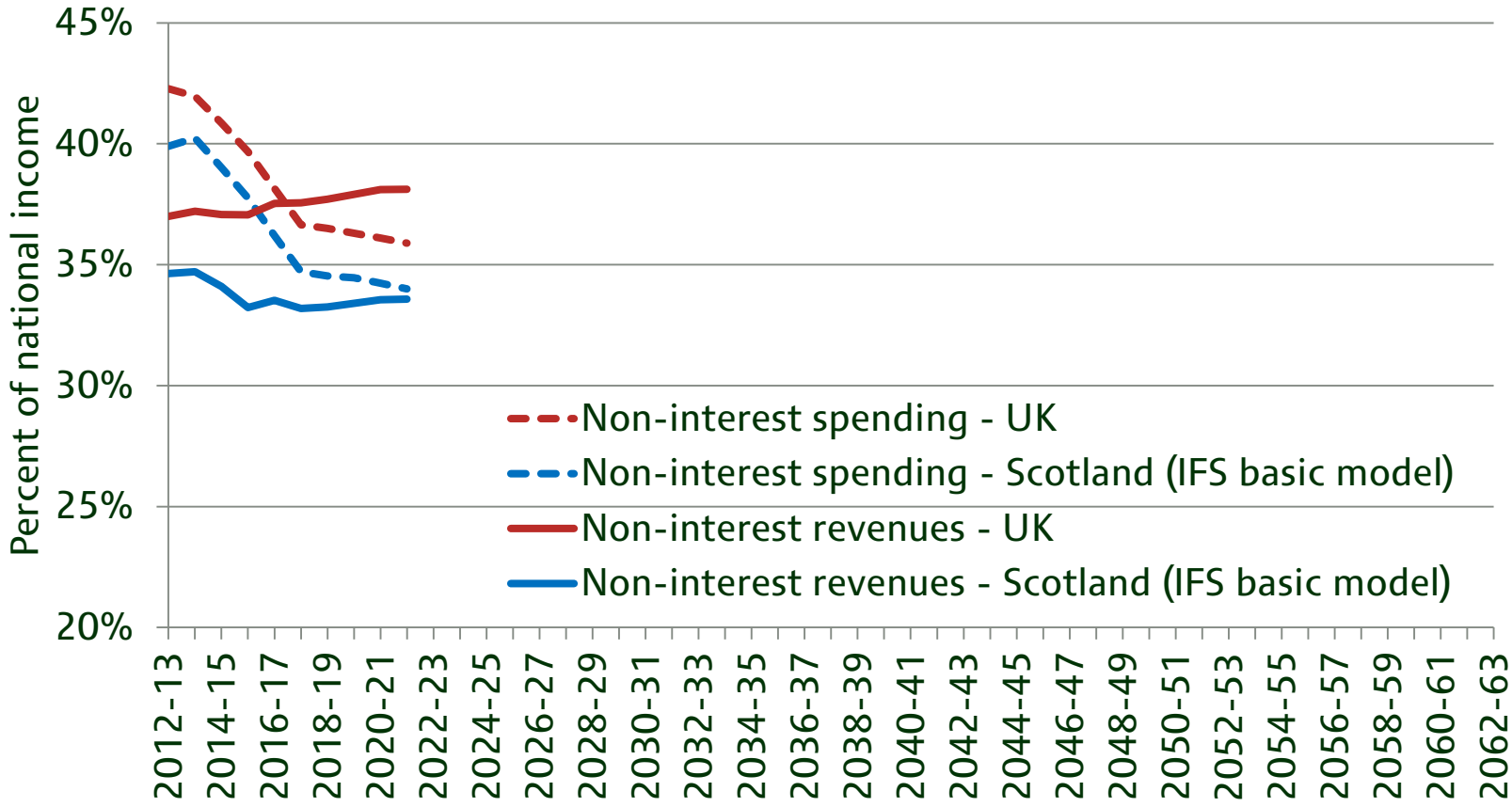
Projections for Scotland: IFS basic model

- Use the same assumptions as the OBR use for the UK in their 'central' projection from their 2013 Fiscal Sustainability Report

Variable/parameter	Assumption made in the basic model
Population growth and demographic change	ONS 'low migration'
Labour productivity growth	2.2%
Nominal debt interest rate payable	Rising to 5% by 2026-27, constant thereafter
North Sea revenues:	
Growth 2012-13 to 2017-18	Decline as forecast by OBR central projection
Growth from 2017-18 onwards	Constant as % national income

- In addition we assume for Scotland:
  - Allocated 94% of North Sea revenues
  - Take population share of accumulated UK debt on independence

Projections from basic model
Non-interest revenues and non-interest spending



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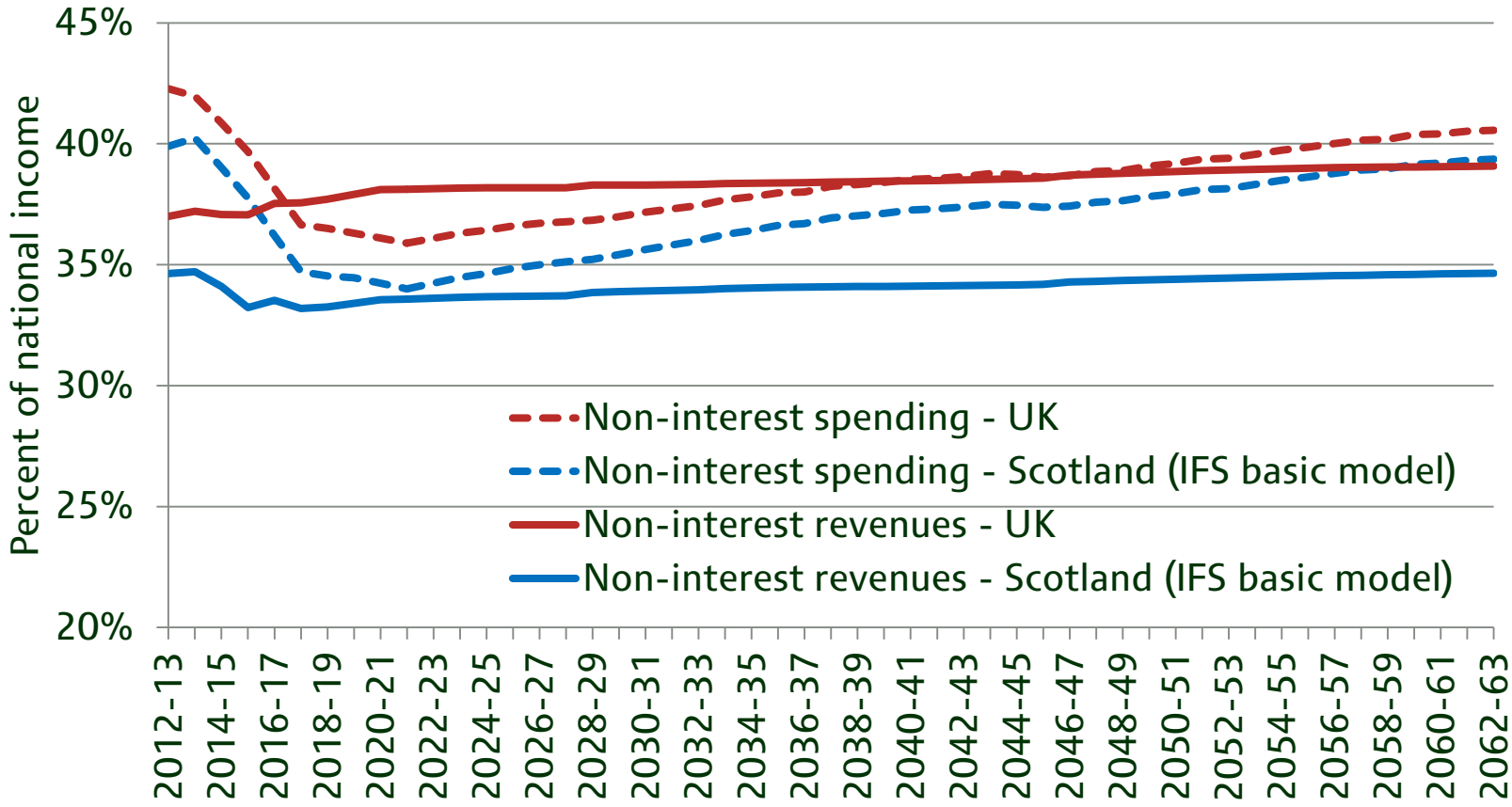

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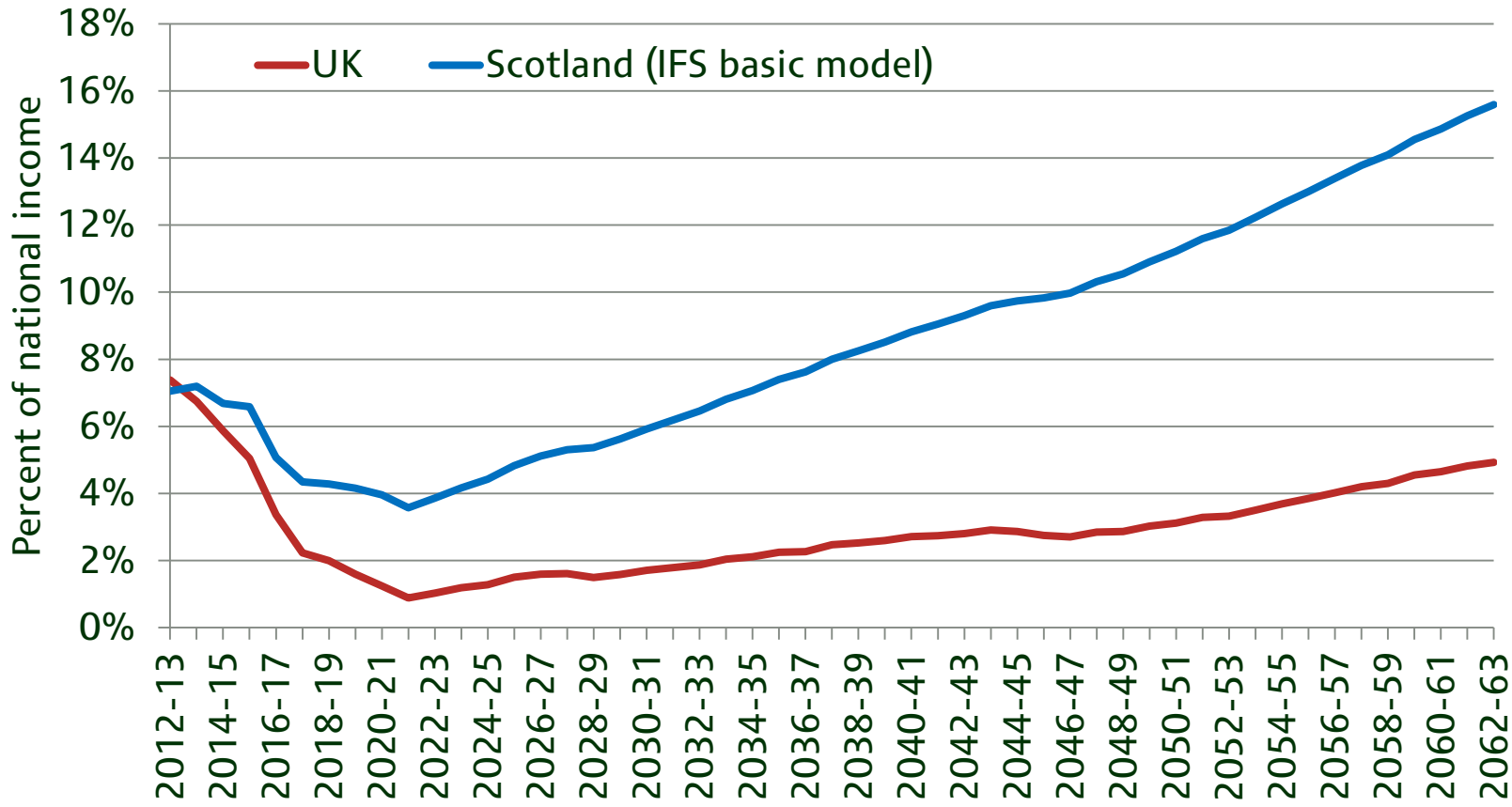
Projections from basic model
Public sector net borrowing



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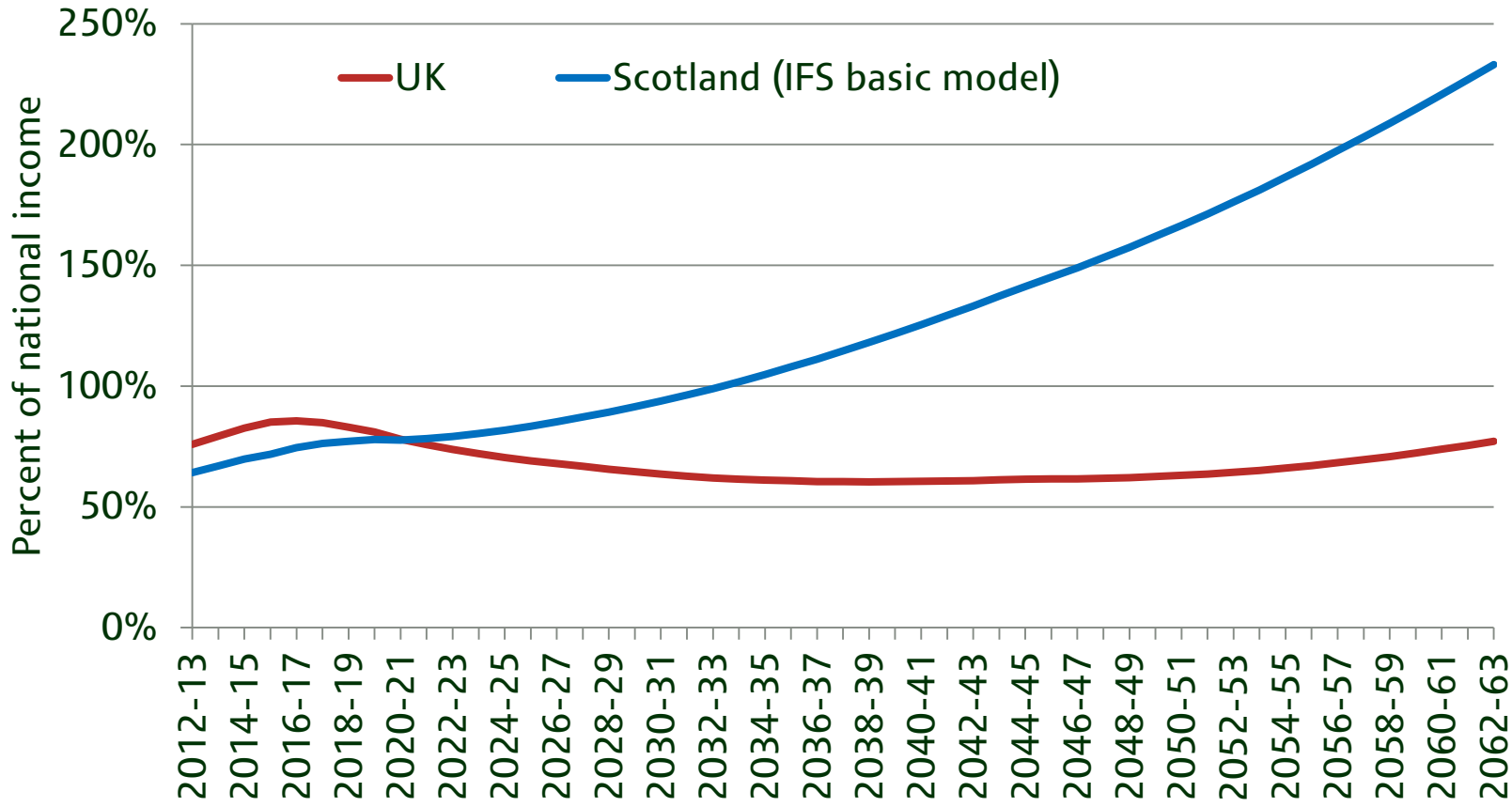

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Projections from basic model
"Fiscal gap"

- What size of fiscal action might be needed to put the Scottish public finances on a more sustainable path?
- Quantify this as:
  - "What size of permanent fiscal tightening, assuming implementation in 2021-22, would be needed to get Scottish debt to 40% national income in 2062-63?"
  - NOT the only way of taking the required fiscal action
    - Though taking action later would require larger tightening
- Estimate Scotland would need 4.1% national income tightening
- Compared to 0.8% national income tightening for the UK