

A QUESTION OF GROWTH

Jennifer Erickson

INTRODUCTION

The Scottish economy is in a state of relative decline. The corollary to this statement is simple: we should do better, we can do better and financial independence is an invaluable tool to help us do better.

Scottish Affairs was right to devote a whole issue (autumn 2002) to the issue of financial independence (also known as fiscal autonomy). The problem with much of the analysis presented, however, was that it was backward-looking and static. It focused on a particular version of what has happened in the past rather than asking why those things happened or what could happen differently in the future.

This article will explore a more dynamic set of issues:

- what the analysis of Westminster and the Scottish Executive tells us about the Scottish economy;
- what else we need to know about the Scottish economy;
- what financial independence would mean and how it could set the stage for growth.

WHAT WESTMINSTER TELLS US ABOUT THE SCOTTISH ECONOMY

The Chancellor has used his last two major statements to the Commons to herald the success of the British economy. He noted that the UK had enjoyed

Jennifer Erickson is Senior Economic Adviser to the Scottish National Party.

A Question of Growth

five successive years of growth and that unemployment in the UK was lower than in the US and Japan. What he did not mention, however, is that Scotland was crawling out of a recession (with many important sectors still in recession) – meaning negative growth – and that unemployment in Scotland was 25% higher than in the US and Japan. Apparently, there was no time to address these things. But there was time to address bingo. The Chancellor mentioned bingo taxes five times.¹

This is not a flippant point. It highlights that the UK Treasury is not overly concerned with the Scottish economy. Whether this is because it views it as inconsequential (amounting to roughly 8% of the UK economy) or because it views it as the charge of the Scottish Executive is not clear.

As for the Scotland Office, we know that over £24m has been spent since devolution to support Ms. Liddell and her predecessor.² What they have done for the economy is a more difficult question. In November 2001, when the Scottish economy was in recession, Ms. Liddell praised it as 'performing well.'³ Pointing out this indifference is important because what is at stake is very real. On unemployment alone, if Scotland could match the UK average, there would be than 30,000 more jobs in Scotland.

WHAT THE EXECUTIVE TELLS US ABOUT THE SCOTTISH ECONOMY (GERS)

The Executive's most scrutinised document on the economy comes in the curious form of GERS (**G**overnment **E**xpenditure and **R**evue in **S**cotland) – an annual publication which offers a snapshot of Scotland's finances from two years ago. Each year the Executive uses this document to claim that Scotland does not pay its own way and is reliant upon the United Kingdom to support its public expenditures. Even if this were true, it would be a strange sort of endorsement to give to their management of the economy.

¹ *Hansard Budget Statement 17/4/02 & Pre-Budget Statement 27/11/02.*

² *Scotland Office. Resource Accounts and Departmental Accounts.*

³ *Hansard. Scottish Grand Committee 28/11 2001.*

Scottish Affairs

The beginnings of GERS have been well documented. It was originally conceived as a confidence-deflating measure for Scotland that would take wind out of the sails for devolution and independence. A leaked memo from Ian Lang, then Secretary of State for Scotland, said of GERS, 'we are engaged in a complex exercise to outflank three other parties, each of whom threatens us in a different way. This initiative could score against all of them.' So GERS was originally a political exercise. Not much has changed. And, yes, it is a very complex one.

There are numerous problems with the accounting methodologies used in GERS. Anyone interested in exploring these deficiencies should read the Fraser of Allander piece by Jim Cuthbert and Margaret Cuthbert.⁴ Here Cuthbert and Cuthbert highlight problems with the calculations for income tax and corporation tax, to name but two. Indeed, the latest GERS (released in January 2003, it deals with 2000/01) notes that 'the calculations to derive a fiscal position for Scotland are subject to *inevitable imprecision* due to the need to estimate a number of elements of both expenditure and revenue.'⁵ (emphasis added)

While there was good reason to question the data used in GERS in the past, there is an even better reason now. Two of the most important proxies used in GERS are Scotland's share of UK GDP and data from Regional Accounts. As at publication of the most recent GERS both were unknown.

In November of 2002, the Office of National Statistics posted an innocuous looking press release entitled 'Regional Gross Value Added.'⁶ But what this document actually contained was the admission that ONS had been miscounting the economy for the last ten years. While the growth of London had been understated by £8bn in 1999 (the most recent year available), the size of Scotland had been overstated by over £1bn in the same year.⁷ So in

⁴ Cuthbert, Jim and Cuthbert Margaret 'A critique of GERS: Government Expenditure and Revenue in Scotland', *Fraser of Allander Quarterly Economic Commentary*, Volume 24, number 1, 1998.

⁵ *Scottish Executive, Government Expenditure and Revenue in Scotland 2000-2001*, p. 43.

⁶ ONS. Press Release. 21/11/02.

⁷ ONS. Press Release. 21/11/02.

A Question of Growth

effect the extent of Scotland's relative decline had been hidden for years in a larger-than-Enron style accounting gaffe.

But the statistical plot thickened only three weeks later, when ONS issued a release saying it was withdrawing its ten-year reassessment on the grounds that it had found more mistakes in the data.⁸ What's more, their intention to release 2000 and 2001 GDP data in December of 2002 was delayed indefinitely. (As at writing, ONS still has no date for publication.)

Regional accounts – which deal with revenues from things like spirit and betting duties – could not be released until ONS had cleared up the GDP problems.

Some assert that the government is trying to massage the data and hide sticky subjects. The answer may be far more benign but perhaps just as problematic – the government doesn't know.

These data problems highlight the futility of the Executive's calculations. Nonetheless, the Executive published GERS on January 20th 2003. GERS cited a 2000-01 non-oil deficit of £5.4bn – up from the purported £4bn deficit in 1999-00. With oil, the deficit decreases to £1.2bn – roughly a third of the allowable deficit under Maastricht.⁹

The Scottish National Party published a document in advance of GERS showing that minor changes to GERS show Scotland to have been in surplus in 2000-01.¹⁰ The first change was to income tax. The Survey of Personal Incomes (SPI) attributed Scotland with 8% of UK income tax revenues in 1996-97. By 2000-01, SPI attributed Scotland with 6.9% of revenues, a decrease of 14% in 4 years. Andrew Goudie, Chief Economist, wrote in last autumn's **Scottish Affairs** that 'there are important concerns over the quality of the Scottish data.'¹¹ In the past, the SNP adjusted the SPI for the inaccuracy as shown by the DSS 1% survey in PAYE receipts, which showed

⁸ ONS. *Press release. 10/12/02.*

⁹ *Scottish Executive, Government Expenditure and Revenue in Scotland 2000-2001, p. 14.*

¹⁰ *Scottish National Party. 'Moving Beyond the Subsidy Myth.' 2003.*

¹¹ *Goudie, Andrew. 'GERS and Fiscal Autonomy.' Scottish Affairs. Autumn 2002, p. 69.*

Scottish Affairs

SPI undercounted Scotland by 5%. The survey has since been discontinued, but a similar adjustment – which coincides with a mid-point in the volatility in the SPI since 1995-96 and also a mid-point between Scotland's SPI-cited income tax share and Scotland's GDP share – suggests Scotland's income tax share is 7.6%. Additionally, the SNP advocated several changes to the GERS revenue methodology as recommended by the House of Commons library. Smaller categories such as stamp duty and fuel duty can be counted by other measures which then give different answers.

The point is not to find more favourable sources for Scotland; the point is that if two research bodies can reasonably choose different sources, then it further points to the fact that GERS is not the definitive word on Scotland's fiscal balance.

But it is a mistake to be distracted by haggling over sources for individual revenue categories as though this were the key to the debate. Although there is strong evidence of a surplus, even if we accepted the GERS analysis of £1.2bn deficit, this would be largely irrelevant. This point is important because it injects more intellectual honesty to the debate than most newspapers have the interest to print. Even if Scotland were in deficit, this would not be a tragic fate. There are four reasons for this.

First, as Gordon Brown is wont to tell us, what matters is how an economy performs over a cycle. Over the past 20 years, on government figures, Scotland has been £24bn in surplus while the UK was £410bn in deficit.¹² So while the UK had an average deficit of 1% of GDP, Scotland had an average surplus of 3.6% of GDP. Secondly, deficits – within reason – are normal. Figure 1 shows 15 year average surplus/deficits. While Scotland would be in slight surplus (again, on government figures) it is in rarefied company. Only two European Union countries can claim surpluses over this period (Luxembourg and Finland). That Italy, Germany, Sweden and most other countries around the world are typically in deficit does not mean that they cannot be independent. So why the double standard?

¹² Murkens, Jo Eric, Peter Jones and Michael Keating. *Scottish Independence: A Practical Guide*. Constitution Unit: 2002, p. 191. **House of Commons library analysis of 2002 FSBR**. While true that Scotland's surplus includes oil, so does the UK deficit. The strangeness is not in including oil, rather in excluding it.

A Question of Growth

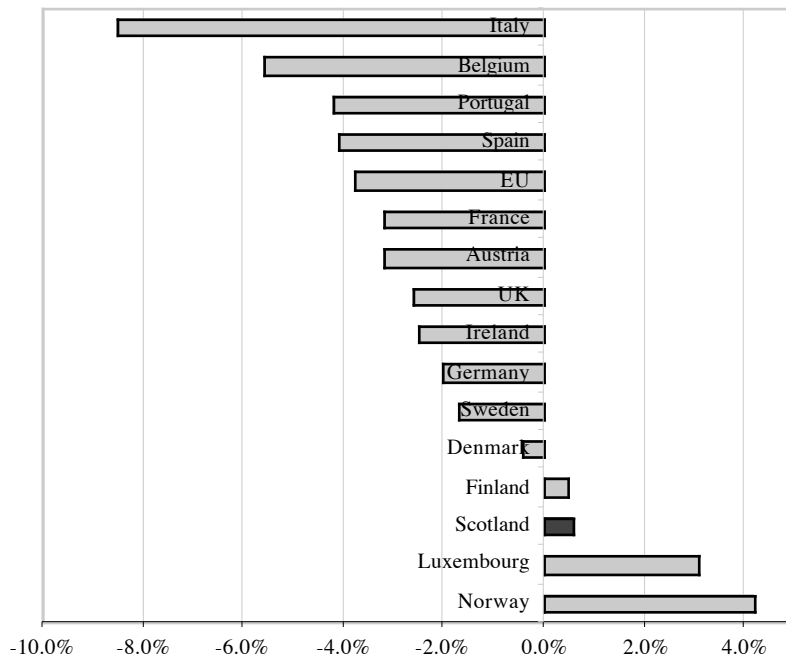
Iain Gray recently posed a question in **The Scotsman** about what he termed Scotland's £1.2bn deficit: 'How would we meet a shortfall? Well the choice is simple: potentially dramatic increases in tax rates; major cuts in public spending or crippling borrowing.'¹³ Such talk is disingenuous in the extreme. Such a deficit would be 1.2% of Scotland's economy; in the same year, the Euro area average deficit was 1.3% of GDP: see figure 2.¹⁴ So even if we accept the Executive's analysis, Scotland still performs in line with the world's wealthiest countries.

¹³ Gray, Iain. 'Scotland Best-Served by Staying within the UK.' Scotsman. 21/2/2003.

¹⁴ OECD, **General Government Finance Balances, 2001**.

Scottish Affairs

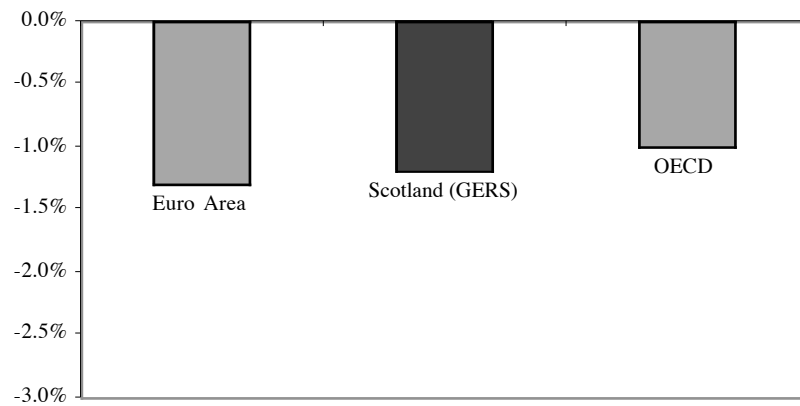
Figure 1
Surplus (+)/Deficit (-) as % of GDP – 15 Year Average



source: *OECD General Government Finance Balances, 1985-2000, Constitution Unit.*

Figure 2

**Alleged GERS Scottish Deficit as % of GDP
Compared with Euro Area and OECD**



source: OECD General Government Finance Balances, 2001; GERS 2000/01, Net Borrowing with Oil.

In fact, moving to the third reason why a potential deficit is not disastrous is because the UK itself has announced a £101bn deficit over the next five years, averaging roughly 2% of GDP.¹⁵ Most critics think the Treasury is being optimistic with these predictions; if Brown's November calculations are as off as his April calculations were, then the five year deficit could top £150bn see figure 3.¹⁶ So unless the Minister for Enterprise is suggesting that the UK faces the dire choices he says confront Scotland, then he is either

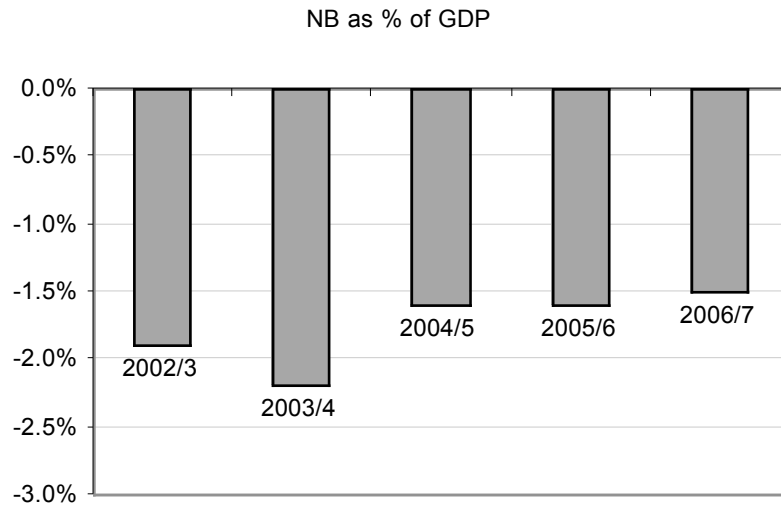
¹⁵ *Pre-Budget Report 2002.*

¹⁶ *Pre-Budget Report 2002; FSBR 2002.*

Scottish Affairs

misrepresenting the facts or he shows a surprisingly limited knowledge of government finance.

Figure 3
UK Net Borrowing as % of GDP



source: Pre-Budget Report 2002.

The final reason that a potential deficit is not overly problematic is that even if a deficit did exist, it, too, could be eclipsed by revenues from growth. In other words, a surplus can turn to a deficit if an economy doesn't grow to support public spending. And similarly if an economy has a manageable deficit, this can quickly turn to a surplus if it grows and brings more money to the government.

WHAT ELSE WE NEED TO KNOW ABOUT THE SCOTTISH ECONOMY

Eddie George, Chairman of the Bank of England, said 'if you actually look at the facts, the Scottish economy has performed pretty well in line with the UK economy.' So lets look at the facts.

Over the past twenty-five years Scottish growth has lagged UK and EU growth: table 1. These seemingly small differences represent a dramatic opportunity cost to Scotland which has been played out over the last generation. If Scotland had matched the modest UK growth, each Scot would be £2000 richer now. If Scotland had hit the OECD rate then Scots would be £4600 richer per person. And if Scotland had performed in line with other small EU countries, the increase would be an impressive £5500 per person.

Table 1
25 Year Growth Gap

	small EU	OECD	UK	Scotland
Avg Yrly Growth	3.1%	2.9%	2.3%	1.7%

Source: OECD 20 20 Database; ONS; Fraser of Allander Institute.

The follow on effects of this low growth have been painfully visible. In 1984, the average Scottish male earned the same wages as the average UK worker. Now, the average Scot earns £2000 less per year than workers south of the border.¹⁷ The unemployment gap (30,000+ jobs) has already been cited. And the population gap which in many ways results from – and continues to perpetuate – these problems is no less shocking. If Scotland had maintained its share of UK population over the last fifty years, there would be 1 million more people living in Scotland.¹⁸ And, looking to the future, while the UK

¹⁷ *New Earnings Surveys, 1984, 2002. There is an earnings gap between women in Scotland & the UK as well, though the trend has been more constant and less pronounced.*

¹⁸ *House of Commons library.*

Scottish Affairs

population increases by 10% over the next forty years, the Scottish population is predicted to decrease by 10%, meaning Scotland will have a population of 4.5 million instead of the current 5 million.¹⁹ Perhaps more worryingly are the demographics behind these numbers; the Government Actuary tells us that Scotland will have more pensioners than children under 16 by 2011.

None of this is to suggest that Scotland's economy is a basket case. After all, Scotland is still the eighth wealthiest country in the OECD.²⁰ Even if the North Sea delivered no more revenues, Scotland would still be the twentieth richest country in the world. The UK is nineteenth.²¹ But this status should not make us complacent to the challenges the Scottish economy faces. While the Chancellor concerns himself with bingo taxes, it's time the Scottish Executive and the Scottish Parliament concerned themselves with capitalising on the enormous potential that exists within the Scottish economy and turning a situation of relative decline into one of steady growth.

FINANCIAL INDEPENDENCE

With an educated work force, ample resources and world-renowned financial, technological and scientific sectors, there is no good reason for the Scottish economy to have logged the lacklustre performance we have seen over the last few generations. There is a reason, just not a good one. There has been no sense of responsibility for the Scottish economy. And while ignored by decision makers, Scotland has been locked into a constitutional arrangement that does not allow Scotland to play to its strengths, forcing it to compete on the so-called 'level playing field' of the UK which inordinately favours London and the South East.

Financial independence would first require Scottish politicians to raise their game and take responsibility for the progress of the Scottish economy. Currently, Scotland has control over council tax, business rates, and the power to vary the basic rate by 3p. According to David Heald and Alasdair

¹⁹ *Government Actuary. Mid 2001 Population Projections.*

²⁰ *OECD. GDP per Capita (Purchasing Power Parity), 2001. Scottish GDP with oil included at 116% of UK figure, in line with House of Commons library suggestion.*

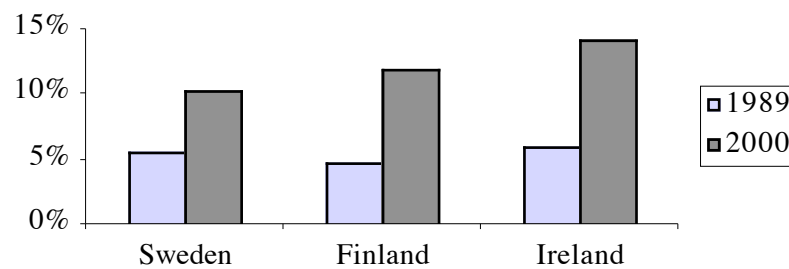
²¹ *OECD, GDP per Capita (Purchasing Power Parity), 2001.*

A Question of Growth

McLeod's article in **Scottish Affairs**, Scotland has control of 15% of its finances.²² Compare that with Catalonia (35%) and the state of Nevada (76%) and Quebec (84%). Making legislatures responsible for their own finances in and of itself has an undeniable focusing power. One wonders if Labour and the Liberal Democrats could have sustained a programme concerned with dog fouling and high hedges if they actually had to answer for low R&D spend and floundering business survival rates.

But once Scotland has financial independence, what should the Parliament do with it?

Figure 4
Corporation Tax Take as % of Total Revenues 1989 vs. 2000 (Post Tax Changes)



source: Swedish Ministry of Finance; Irish Department of Finance; Finnish Ministry of Finance.

Scotland needs a competitive edge. In any monetary union – the UK, the EU, the US – there is a tendency for power to gravitate towards a few centres. To combat this, other areas have to have an opportunity for differentiation. One

²² Heald, David and Alasdair McLeod. 'Fiscal Autonomy Under Devolution: Introduction to Symposium.' *Scottish Affairs*, no. 42, p. 5.

Scottish Affairs

of the most powerful forms of differentiation is tax variance. That business rates are currently 10% higher in Scotland than in England sends totally the wrong signals and puts an unfortunate burden on indigenous businesses. Once this anti-competitive practice has been combated, Scotland should seek a distinct competitive edge through lowering corporation tax. Other small countries have done it and the results have been dramatic – businesses have come and overall corporation tax take has risen: figure 4.

And even within a federal government like the United States, states compete on a panoply of taxes that suit their unique economic needs: table 2.

Table 2
Examples of Different Tax Rates by State

	Income tax	corporation tax	sales tax	gasoline tax
Massachusetts	5.3%	9.5%	5.0%	21%
California	1% - 9%	8.8%	8.25%	18%
Florida	0%	5.5%	8.5%	13.9%
Nevada	0%	0%	7.25%	24%
Montana	2% - 11%	6.75%	0%	27%

source: Federation of Tax Administrators. 2002.

Of course, there are other non-tax measures Scotland should consider as well. Increasing transportation investment, quickly rolling out broadband access, and actively encouraging immigration are three other strategies which would help re-position Scotland for growth. Under the current system of devolved powers, the Scottish Parliament would be hard pressed to make any significant progress in these areas.

One thing that the Scottish Parliament can influence is education and skills, and the Executive is right to invest in these. But the problem with relying on the Smart, Successful Scotland strategy to turn things around is that if you educate people but do not have the opportunities in the Scottish economy for them to use those skills, they will either be underemployed or they will leave.

A Question of Growth

In short, you can create smart, successful Scots without creating a smart, successful Scotland. That's why supply side measures are not enough.

Financial independence means having full control over Scotland's economic levers, including the independence to set tax rates, the independence to promote Scottish interests abroad (consider the current fishing crisis for just one example) and the independence to choose the monetary policy which will best favour Scottish industries.

It is debilitating to have a culture of no power and block grants. Strange but true, the SNP wants the Minister for Enterprise and the Minister for Finance to have more power than they do. The SNP argues that the Executive should have real powers to affect the Scottish economy; the Enterprise Minister has responded that he prefers the 'favourable economic transfers that being part of the UK brings.'²³ With this culture of dependency, the prospects for change under the current administration look bleak.

Importantly, the issue of financial independence is not purely party political. In recent months we have seen business and academic leaders speak out in favour of financial independence. And in a NFO/System Three poll, 70% of Scots agreed the Scottish Parliament should be responsible for setting and collecting taxes.²⁴

CONCLUSION

A generation ago, who would have predicted that Ireland and Finland would now be richer than the United Kingdom? Economies are dynamic. And the sooner we release our potential as small neighbouring countries have done, the better off we will be. To do that we must first acknowledge the scope of the problem. Then we have to switch the debate from how to amble along within the current settlement and eke as much money as possible out of Westminster to how to capitalise on Scotland's strengths and give ourselves the tools to achieve growth.

²³ Gray, Iain. 'Scotland Best-Served by Staying within the UK.' Scotsman. 21/2/2003.

²⁴ NFO/System Three Poll. July 2002. Sample size: 918.

Scottish Affairs

We are now at a critical decision point. Either we choose to make difficult decisions and try to change things or we duck the debate entirely and focus on static issues from the past. If we choose the former option, then we have to start a serious debate about financial independence. But whatever the choice, we must be prepared to answer for it.

March 2003