ECO.

SCOTTISH INDEPENDENCE

Economic questions and research evidence

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Some articles have been abridged for printing. Read the collection in full on the Economics Observatory site.

EDITORIAL

Welcome.

The Economics Observatory was conceived in late March 2020 as a response by the UK's economic research community to the many questions from policy-makers and the public about the economics of the Covid-19 crisis and recovery. With funding from the Economic and Social Research Council (ESRC), we were able to mobilise the expertise of economists from a wide range of universities and research institutions to address immediate concerns about the potential damage that lockdown and economic downturn would cause to businesses, jobs, incomes, education and mental health.

But we also wanted to explore some long-term issues raised by the pandemic and its aftermath – including the prospects for big cities with a more permanent move to working from home; and how to make up the learning losses suffered by a generation of children and young people. And we always planned to go on to explore questions about other big challenges, including digital technology, food insecurity, regional inequality and climate change.

One such issue is devolution and, in particular, the possibility of a second referendum on Scottish independence. Graeme Roy of the University of Glasgow, one of our lead editors, and Stuart McIntyre of the University of Strathclyde, a member of our editorial board, kindly volunteered to commission a series of Observatory articles on the economic issues at the heart of Scotland's constitutional debate. Just as we did with the pandemic, the central idea was to present answers to questions based on the best economic analysis and latest research evidence.

This publication brings some of those pieces together as a contribution to current and future Scottish policy debates. It is also the precursor of a new Observatory initiative that the ESRC is funding: the establishment of a base in Glasgow to mirror our policy engagement in Whitehall and Westminster with similar links in Scotland, Wales and Northern Ireland. This regional hub will allow us to widen our engagement activities with policy-makers from the devolved nations and to build new connections between researchers, practitioners and the public. We look forward to working with you.

Romesh Vaitilingam
Editor-in-Chief, Economics Observatory

Big economic questions.

Scotland may soon have a second referendum on whether to remain part of the UK. Economic issues will be a key part of the debate – from the fiscal policy institutions needed for an independent country to choice of currency and the future relationship with the European Union.

/ Graeme Roy / Stuart McIntyre /

Scotland's first minister has announced the intention to hold a second Scottish independence referendum by the end of 2023. This would be a little less than a decade since the 2014 referendum, in which nearly 45% of voters were in favour of Scotland becoming an independent country and just over 55% were against. The UK government has, so far, rejected calls for a second referendum.

Economic issues continue to be at the forefront of arguments for and against Scottish independence. What economic theory and data can be used to help us to understand the issues at the heart of this debate? What do they tell us about the opportunities and challenges of independence for both Scotland and the rest of the UK? And what is left unknown?

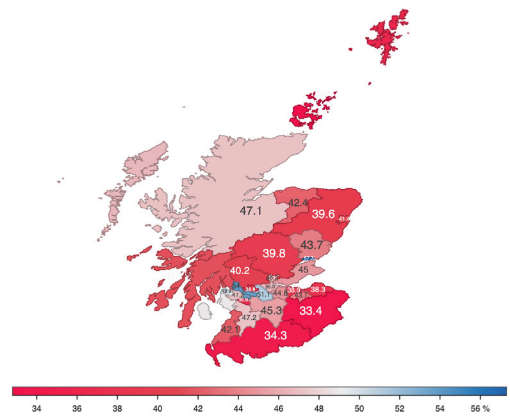
Scotland's constitutional debate

In 2014, the people of Scotland voted 55% to 45% in favour of remaining part of the UK. Turnout was remarkably high at nearly 85% of the electorate, which for the first time included 16 and 17 year olds. Since then, voters in Scotland have remained energised about the constitutional debate.

A key argument made by the pro-Union side during the 2014 referendum campaign was that independence would lead to Scotland exiting the European Union (EU). This is why, following Brexit, debates about a second independence referendum gained a new edge, particularly as the Scottish electorate voted in favour of remaining in the EU by a margin of 62% to 38%.

The Scottish government argues that the UK's decision to leave the EU represented a 'material change in circumstance' that justifies a second referendum. In contrast, the UK government argues that the 2014 vote settled Scotland's constitutional status for at least a generation.

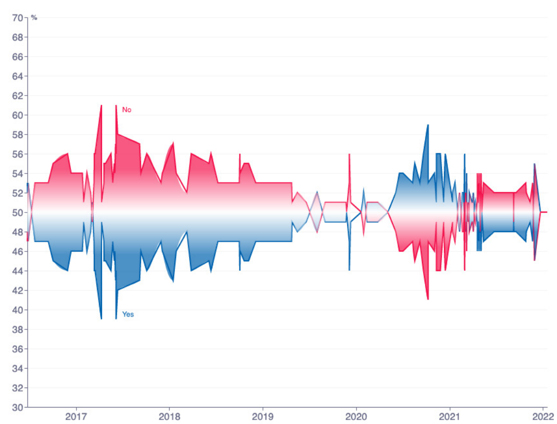
Figure 1: Map showing the 'yes' voter share in the 2014 referendum



Source: BBC

The latest opinion polling continues to show that the country remains relatively evenly split on the question of Scotland's constitutional status.

Figure 2: Independence referendum vote intention since the EU referendum



Source: What Scotland thinks
Note: Based on polls that asked how people would vote in response to the question 'Should Scotland be an Independent country?' Those saying 'don't know' or 'would not vote' exluded.

Debates about if and when a second referendum might take place are likely to rumble on, as will the political arguments for and against independence.

Against this backdrop, we thought that it would be useful to help to inform the debate by asking leading experts to look at what the evidence tells us – and crucially doesn't tell us – about important economic issues that lie at the heart of the discussion on Scottish independence. In a series of articles over the next few weeks, economists from across the UK, and further afield, will be providing short reviews of some of these key issues.

Our purpose is not to argue for or against independence (or indeed for or against a second independence referendum), but simply to help people become more informed about the core arguments and to highlight sources of information and data that – if you are interested – you can use to find out more about these issues for yourself.

What are the key areas of debate?

One of the challenges in attempting to bring economic evidence to bear on questions around Scottish independence is that there are few historical precedents to which we can turn for lessons. That being said, in this series we will be looking at some other experiences, including Ireland (Eoin McLaughlin and Sean Kenny from University College Cork) and the Czech Republic/Slovakia (Jan Fidrmuc, Université de Lille and Jarko Fidrmuc, Zeppelin Universität) to see what insights – with appropriate caveats – emerge from their experiences.

More generally, this means that when discussing Scottish independence, we need to be clear about the uncertainties that exist when trying to predict what might happen. The need for detailed negotiations to establish an independent Scotland and its terms of 'exit' from the UK on all manner of issues, including the division of all assets and liabilities, only adds to the uncertainties.

As we will see throughout the series, there are also important gaps in our economic data and statistics. If there is one conclusion that we hope people will take from these articles therefore, it is that any bold claims – by either side of the debate – that assert exactly what will happen after Scottish independence need to be taken with a pinch of salt. Issues of uncertainty (good and bad) and how they might affect businesses will be a source of discussion in an article by Brad MacKay (University of St Andrews).

What are the key issues on which economics can help to inform the debate?

One of the most controversial areas is that of currency. The currency choice of a country reflects much more than simply the type of bank notes and coins in your pocket. Instead, it underpins all aspects of macroeconomic policy and financial stability in an economy.

Like all other parts of the UK, Scotland currently uses sterling, with monetary policy set by the Bank of England. If Scotland were to become independent, it would need to decide on its future currency and monetary system. This may include establishing its own currency, central bank and financial regulation arrangements or sharing another currency with key partners (for a detailed discussion of options – in the context of the 2014 referendum – see Armstrong and Ebell, 2014).

In 2014, the Scottish government's position was to enter a formal currency union with the UK, with the Bank of England acting as the central bank for a 'sterling zone'. But in advance of the referendum, the UK government said that it would not agree to such an arrangement in the event of Scottish independence.

The current position of the Scottish National Party (SNP) – the current party of government and by some distance the largest pro-independence political party in Scotland – is that it will seek to use sterling post-independence with or without a currency union. Without a formal agreement this would be akin to dollarisation (which is known in Scotland as 'sterlingisation'). Such a model has not been tried in a country with such a high income as Scotland and has typically been the chosen regime in countries like Panama. John Kay has recently spoken on this option in a public lecture at the Royal Society of Edinburgh.

Other options are available, ranging from establishing a new Scottish currency that could either 'float' (with the exchange rate determined by market supply and demand, as is the case with the pound today) or be 'fixed' (to the pound, to a basket of currencies or to another currency such as the dollar or euro). A fixed exchange rate could be 'managed' allowing some flexibility at the margins.

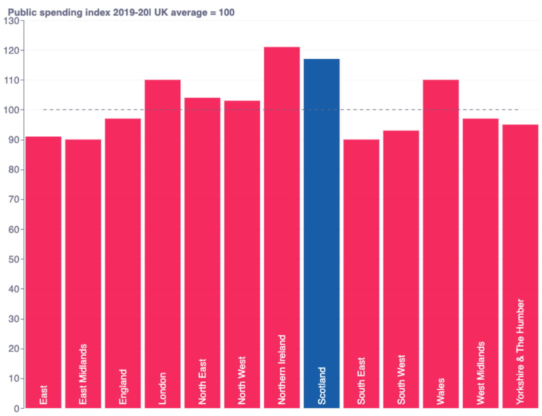
Macroeconomists will debate the strengths and weaknesses of each arrangement, but a particularly tricky issue to navigate is how to make the transition from one steady state to another. Ronald MacDonald (University of Glasgow) and Iain Hardie (University of Edinburgh) will discuss some of these issues in their articles on the currency choices facing an independent Scotland.

Another issue is fiscal sustainability. As part of the UK, Scotland does not run a separate system of public finances. The Scottish government has its own budget, but it must balance that every year (albeit with some modest borrowing powers). Running a sustainable fiscal position will be important for a newly independent Scotland.

There is much debate about what Scotland's fiscal deficit might look like under independence. This reaches a crescendo each year on the day of publication of the Scottish government's Government Expenditure and Revenue Scotland (GERS) report.

Away from the controversy, what do we know about the position of Scotland's public finances? (A useful summary is provided in Roy and Spowage, 2021). Scotland currently has higher public spending per head than the UK as a whole. This is largely driven by the Barnett formula, which has locked in higher relative spending in areas such as health and education in Scotland, but also reflects a slightly larger take-up of social security payments.

Figure 3: Identifiable public spending per head by devolved nation and English region



Source: HM Treasury

At the same time, onshore tax receipts per head are slightly lower than in the UK as a whole (by approximately £380 per head in 2020/21). The result is a larger estimated fiscal deficit vis-à-vis the UK (-8.8% versus -2.6% in 2019/20, and -22.4% versus -14.2% in 2020/21 at the height of the pandemic). David Phillips (Institute for Fiscal Studies) will discuss this further in an article on the core fiscal issues for an independent Scotland.

A third key consideration is around economic borders. The rest of the UK is Scotland's largest trading partner, while an independent Scotland would of course become an important trading partner for the UK. In 2019, around 60% of Scottish exports were to the rest of the UK. This compares with 19% of total exports destined for the EU.

Table 1: Scotland's exports

Export destination	Value of exports (2019)	Growth since 2010	Share of total exports
International	£35.1 billion	43.0%	40.2%
... of which EU	£16.4 billion	49.6%	18.8%
... of which non-EU	£18.7 billion	37.8%	21.4%
Rest of the UK	£52.0 billion	15.3%	59.8%

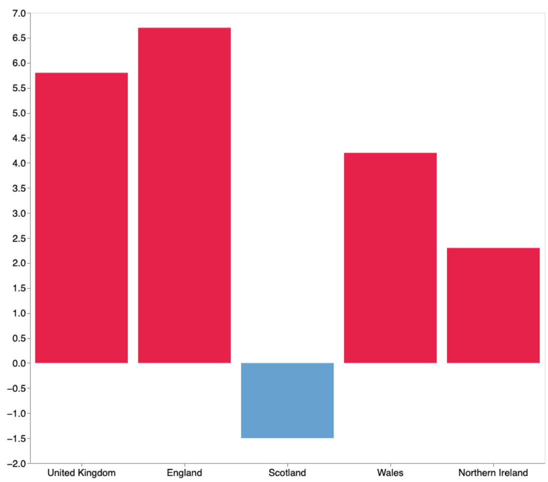
Source: Export Statistics Scotland

Like the rest of the UK, Scotland has now left the EU's single market and lies outside the EU's customs union. Should an independent Scotland seek to rejoin the EU's single market and/or customs union, then it would have to contemplate an economic border between Scotland and the rest of the UK. Thomas Sampson (London School of Economics) will discuss these issues in his article. As the experience of Ireland has shown, it is possible to shift relative trade priorities to new markets, but such changes take time to materialise.

A fourth key set of issues revolves around preferences for greater levels of autonomy and powers to do things differently vis-à-vis economies of scale and 'pooling and sharing'.

Proponents of Scottish independence argue that it would provide greater opportunities for policies to be better targeted to the strengths of the Scottish economy, helping to improve economic performance over the longer term. They often point to the successes of small independent countries elsewhere in the world, many of which have higher living standards than the UK. There are a number of areas where the Scottish economy is different to the UK, such as in demographics and the sector mix of the economy, so a different policy approach might be an advantage. Ewan Gibbs (University of Glasgow) discusses how debates about Scottish independence have become interwoven with our understanding of deindustrialisation in Scotland in recent decades.

Figure 4: Projected population change by country (2020 to 2045)

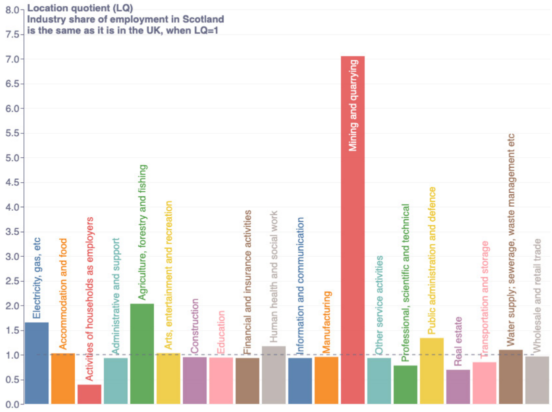


Source: National Records Scotland

Opponents of independence argue that while some (or all) of this might be true, in the modern global economy, all national economies operate under constraints and that Scotland gains from being able to tap into UK-wide resources that strengthens its economy.

Proponents of independence also frequently argue that Scotland's interests – over the long term – might not be best served in a UK economy that has high levels of inequality (both by income and spatially).

Figure 5: Industry composition in Scotland



Source: Office for National Statistics, authors' calucaltions

Opponents counter that the devolved Scottish government already has substantial levers to influence day-to-day activity in the Scottish economy. What this suggests – and this is covered in an article by Andy Cumbers, Bob McMaster (both University of Glasgow) and Sheila Dow (University of Stirling) – is that a political economy perspective might provide insights beyond simply looking at current data.

Many of these debates owe their origins to the fiscal decentralisation research on the trade-off between decentralised versus centralised decision-making and studies on the 'optimal size of nations' (Oates, 1999; Alesina and Spolaore, 2003). Economic history too points to important work on 'persistence' that has so far largely been ignored in debates about Scottish independence. It suggests that constitutional or political change does not always bring immediate shifts in policy choices or economic performance as many 'legacy effects' can act as a constraint (Muscatelli et al, 2022).

Many of these debates have implications for elsewhere in the UK, and colleagues in Northern Ireland (Graham Brownlow, Queen's University Belfast) and Wales (Calvin Jones, Cardiff University) will reflect on what Scottish independence might mean for them. David Bell (University of Stirling) will review what options might be possible for greater fiscal decentralisation in the UK. Finally, there is a discussion about institutions and which ones an independent Scotland would need to establish. Scottish taxpayers already make a contribution to UK-wide institutions. So some of the cost of new institutions required under independence could be offset (in part or in full) by not paying for UK equivalents.

Arguments typically take place over whether any losses of economies of scale (cost-savings from creating larger institutions) are likely to be better or worse than any gains in efficiency and reduced complexity. Tim Besley and Chris Dann (London School of Economics) will discuss issues of fiscal capacity and Gemma Tetlow and Thomas Pope (Institute for Government) will discuss the different institutions of economic policy that an independent Scotland would need.

What has changed since 2014?

One obvious question that people ask is: if decisions over independence are for the long term, what could have changed in the last eight or so years? The answer is quite a lot.

For example, economic conditions have changed since 2014. Like many policy areas explored at the Economics Observatory, the Covid-19 crisis puts an imposing backdrop on debates around Scottish independence – not least on the timing of any referendum. As has been the case around the world, the pandemic resulted in a significant shock to the Scottish economy. At the peak of the lockdown in 2020, GDP fell by over 20%.

There is some evidence that the Scottish economy might be coming out of the Covid-19 recession slightly more slowly than the UK as a whole, but it is difficult to reach any firm conclusion at this stage. But what is more important is that over the last decade, Scotland's economic performance has been weaker than that of the UK as a whole.

The decline in North Sea oil and gas production is a key factor here. In addition to creating a weaker economic backdrop for Scotland's economy, oil revenues – which were forecast during the last referendum to raise around £7 billion per annum – are now on track to raise only around £1.5-2.5 billion per annum for the foreseeable future.

Political conditions have changed too, of course. For example, the Scottish Green Party – which disagrees with the SNP on aspects of Scottish independence, including currency – now have two ministerial posts in the Scottish government.In addition, and as highlighted above, Brexit has changed much of the political context. But as mentioned, this poses some challenging questions about any transition process, as well as throwing up some new opportunities over the long term

Good governance.

/ Gemma Tetlow / Thomas Pope /

Scotland already has devolved powers over many areas of public policy – from running the NHS and schools to its own legal system, as well as some power over tax and social security policies. But not since 1707 has Scotland had complete control over its own monetary policy and public borrowing.

One of the big adjustments that an independent Scotland would need to make, therefore, would be to set up the institutions needed to support its own currency regime and to ensure that the government was able to borrow any money it needed. In particular, it would require a new debt management office, a strengthened independent fiscal watchdog and a new monetary authority to take over activities currently performed for the UK as a whole by the Debt Management Office (DMO), the Office for Budget Responsibility (OBR) and the Bank of England.

There is no precedent for establishing a new economically advanced country. But we can still draw lessons for an independent Scotland by examining the macroeconomic institutions that existing advanced economies have developed (Pope and Soter, 2021; Tetlow and Soter, 2021).

What new institution would be needed to issue government bonds?

Currently, most of the borrowing that is done to bridge the gap between the tax revenues raised in Scotland and the public spending done for the benefit of Scotland is issued by the DMO, which is based in the City of London. While the decision about how much to borrow is a political one, deciding what types of debt to issue should not be. It is instead a technical matter and is, therefore, handled by this independent institution.

The DMO helps to minimise the amount of interest the UK government is charged on its debt by matching the type of bonds issued to the demand that exists. If there is high underlying demand for a particular type of debt, it can be issued at lower cost. For example, over the past decade, the DMO has increasingly favoured issuing index-linked debt (that is, debt on which the interest payment varies in line with the rate of inflation). This is because there has been high demand for such inflation-protected assets from private pension providers (HM Treasury, 2021).

The DMO makes sure that the government's debt stock is manageable over time – for example, by issuing bonds of different maturities to avoid any spikes in refinancing requirements. It can also issue debt in different currencies: invariably UK government debt is denominated in sterling, although the UK has occasionally issued bonds denominated in other currencies, such as the Chinese renminbi (HM Treasury, 2014).

To help to ensure that it could borrow at the lowest possible cost, an independent Scotland would need to establish an effective debt management office of its own to carry out these functions (Pope and Soter, 2021). This task could be entrusted to a new central bank (as is done in Denmark) but it is regarded as international best practice to have a separate debt management office.

This is because there can be a conflict of interest for a central bank. If Scotland were to have its own currency, the central bank (as we describe further below) would be responsible for setting the base interest rate, which feeds through into economy-wide interest rates, to achieve whatever target it was set (such as stabilising inflation or maintaining a currency peg). But if the central bank was also responsible for issuing government bonds, it could be tempted instead to use its interest rate setting powers to reduce the cost of government borrowing.

A new Scottish debt management office would need to establish good relationships with investors worldwide to determine what demand there was for different types of Scottish government debt and to enhance Scotland's reputation with those potential investors. It would also need a sound institutional framework to attract investors.

The UK's DMO provides a good model, as it is well regarded internationally. It maintains a good relationship with the Treasury, while retaining the power and resources to make independent decisions.

But demand for Scottish government bonds would not be determined solely by the actions of a new debt management office. Investors' appetite would also depend on their view of the creditworthiness of the Scottish government and the country's exchange rate regime.

How could institutions bolster the credibility of Scottish fiscal policy?

The borrowing costs facing an independent Scottish government would depend on what investors thought were the prospects for Scotland's future economic growth and how credible they perceived the country's economic and fiscal policies to be. Fiscal policy covers all tax and spending policies – and the resulting levels of borrowing and debt.

To a large extent, investors' perceptions would be shaped by what the government chose to do. But their confidence could also be reinforced by bolstering the role of the existing Scottish Fiscal Commission after independence. In the past decade, many countries have adopted independent forecasters or fiscal councils – such as the OBR in the UK – to assess the reasonableness of their government's fiscal position. These fiscal councils have been shown to be associated with more fiscal discipline, provided they are credibly independent (Debrun and Kinda, 2016).

The Scottish Fiscal Commission has already established a reputation for delivering credible and independent forecasts (OECD, 2019). But the Commission's role would need to expand if Scotland were to become independent, since the fiscal powers of the Scottish government would grow. It would also be important to address existing weaknesses in the operation of the Commission – in particular, its lack of timely access to some necessary information and gaps in some Scottish economic statistics, such as on wages and earnings (Scottish Fiscal Commission, 2020).

Expanding the Commission's role in this way would require some extra resources and reinforcement of its independence from government, including allowing it to conduct more in-depth analysis of longer-term fiscal risks and fiscal sustainability.

Further empowering the Scottish Fiscal Commission in this way and ensuring that it had the resources to succeed would be an important signal from the Scottish government to international markets and should help to develop better fiscal policy.

What new monetary authority would an independent Scotland need?

After independence, Scotland would need to decide what currency regime to have. This would have wide-ranging implications for people's day-to-day lives, how businesses would transact with one another within Scotland and overseas, the currency in which government debt would be issued and what demand there would be for it. The decision would also influence the shape and size of Scotland's economy as it would affect the ease of trading with other countries.

Several different options may be available to an independent Scotland – from retaining the pound in some form or joining the euro to issuing a new Scottish currency that could either float freely or be pegged to another currency. The different options would have deep implications for the Scottish economy, as discussed elsewhere in this series (MacDonald, 2022). They would also affect what type of monetary authority Scotland would need (Tetlow and Soter, 2021).

All advanced economies now have an independent institution (usually a central bank, such as the Bank of England) that operates monetary policy, with a mandate from the government. This separation of monetary policy setting from politics helps to insulate monetary policy from any temptation that politicians might have to use it for short-term political gain. This has been effective in promoting price stability and financial stability (Lybek, 2004).

Research shows that it will be important for an independent Scotland to establish a similar sort of credible, independent monetary authority with appropriate funding and staffing (Tetlow and Soter, 2021). The targets of monetary policy (such as price or output stabilisation or maintaining a currency peg) are more credible when independent experts make decisions rather than politicians who may be swayed by short-term political calculations.

A credible, independent central bank would also make investors more confident in investing in Scotland and buying Scottish government debt because it would reduce the perceived risk that inflation or large currency devaluations would erode the value of their assets.

How could an independent Scotland ensure that its new institutions were successful?

These new institutions would entail some upfront and continuing costs. But these costs need not be high – and they certainly are not sufficiently large as to affect the judgement that one would make either about the merits of Scottish independence overall or the appropriate choice of exchange rate regime after independence (Pope and Soter, 2021; Tetlow and Soter, 2021).

But there could be challenges in attracting the right calibre of people to lead a new debt management office or monetary authority. Having the right leadership would be critical to ensuring these institutions' success, as both would need to establish a good reputation quickly with the private sector at home and abroad.

There may not be sufficient suitably qualified people already based in Scotland and so an independent Scotland may need to pay a premium to attract talent from elsewhere. The UK, for example, found that salary was a sticking point in its attempt to recruit suitably qualified candidates to fill new senior trade roles after Brexit – a type of expertise that the UK civil service had not needed as a member of the European Union (Dean, 2017).

A newly independent Scottish government would need to ensure from the start that these institutions were adequately resourced and given sufficient operational independence. This would be crucial to the success of the new country, as it would help to reassure investors and the wider world that the new government was committed to credible, stable economic and fiscal policies. Scotland could model these new institutions on successful examples in other advanced economies

Tax and spend.

Scotland currently has limited tax-raising powers: its government does not collect or legislate over the broad-based taxes that are needed for high fiscal capacity. Developing a sense of common purpose is critical for nation-building – and it would be a key issue for an independent Scotland.

/ Tim Besley / Chris Dann /

Political economists understand that the power to tax is at the heart of effective states. This is far from being a purely technocratic issue: a government must be able to raise revenues to spend on infrastructure and a range of public services.

But throughout history, enlarging the public purse has been a surprisingly difficult task for many countries. Although since 1998, Scotland has been granted some limited tax-raising powers and autonomy over public spending, the nation currently does not have the capacity to collect broad-based taxes. Hence it is not a strong fiscal state in its own right, given that – under the current constitutional settlement – it is not responsible for its own tax system and lacks the institutions to raise revenues.

A government's accountability rests primarily on how it chooses to spend money rather than how it raises it. This would change were Scotland to become an independent country, and it is important to be aware of the tasks that would be entailed in making such a transition.

The importance of fiscal capacity

There are many politico-economic studies emphasising the importance of fiscal capacity in the history of nation-building. Over the past century, fiscal capacity has increased dramatically (Besley and Persson, 2014). Expanding the base for taxes on income and consumption is the fulcrum of modern fiscal capacity.

Far from impeding prosperity, it is high-growth countries that tend to have a larger share of tax revenues in GDP (Dincecco and Prado, 2016). This is partly because governments with high fiscal capacity have strong incentives to invest in prosperity to maintain and build the tax base; and hence they tend to strengthen other branches of the state that support economic development (Besley and Persson, 2011; Besley et al, 2021). For example, investing in the health and education of citizens or regulating an economy in a way that supports growth will pay dividends in the form of higher tax revenue.

High fiscal capacity can also support protection against economic shocks, as was apparent with the scale of the furlough scheme during the Covid-19 pandemic. It can also increase economic flexibility by sharing the burden of economic transitions, as is likely to be seen in the coming years as we move towards a low-carbon economy.

It is also fiscal powers that enable a state to borrow at reasonable cost. But a good part of building these powers lies in acquiring a reputation for using them wisely and having appropriate constraints in place to underpin this.

Excluding revenues from North Sea offshore oil and gas activity, Scotland's average tax revenue as a share of GDP is 39.2% (over the period from 2016 to 2021). By this standard measure, Scotland looks like a country with high fiscal capacity, in parallel with many high-income countries. Notwithstanding this, most fiscal decision-making still lies with Westminster.

Developing a strong fiscal state requires an extensive state infrastructure, such as a trained and effective bureaucracy to monitor tax collection processes and enforce sanctions (Xu, 2019).

Research has shown that collecting broad-based taxes, such as income tax and value-added tax (VAT), is key to this endeavour (Migdal, 1988; Besley and Persson, 2014). This stands in contrast to more 'basic' taxes, such as trade tariffs, which can simply be collected at ports by monitoring flows of goods.

Revenue Scotland, which was established in 2015 as the nation's tax authority, currently oversees only the collection of fully devolved taxes – the Land and Buildings Transaction Tax (the replacement for Stamp Duty) and the Scottish Landfill Tax. Two other taxes – Air Departure Tax and Aggregates Levy – will also be collected by Revenue Scotland, although full devolution has been delayed.

While Scotland has its share of the administrative infrastructure for income tax collection, it does not currently have oversight over broad-based taxes, which are collected by HM Revenue and Customs (HMRC).

Even though the Scottish government can vary tax bands and rates on income tax, administration is still undertaken by HMRC. Around half of VAT revenues estimated to be raised in Scotland are planned to be assigned to the nation in the future, but again these will be collected by HMRC, with an estimate of how much has been collected in Scotland allocated to the Scottish budget.

Essentially therefore, Scotland's government spending is currently dependent on the fiscal capacity institutions of the UK as a whole, which have been built up over more than two hundred years. Although Scotland has been part of these two centuries of history, does it matter if the current set-up changes?

Where does fiscal capacity come from?

Historically, war has been the key impetus for a state to build its fiscal capacity (Dincecco and Prado, 2012). As the late historical sociologist Charles Tilly's famous aphorism goes, 'war made the state and the state made war'.

Although war is destructive, it can also be a key source for creating a sense of 'common purpose'. November commemorations of the fallen in world wars that take place everywhere in the UK are a collective appreciation of the sacrifices that were made to maintain the territorial integrity and independence of the UK.

Following this logic, creating a sense of common purpose will be key if there is a referendum vote in favour of Scottish independence. If the referendum is divisive, that may not be easy; the ordeal of trying to resolve Brexit in a harmonious way is a salutary experience.

We would expect Scotland to retain the broad administrative and political institutions that are conducive to this, especially strong constraints on executive power and openly contested elections. Of course, much would depend on the future party configuration that emerges in a post-independent Scotland once the raison d'être for the Scottish National Party (SNP) is no longer relevant.

Robust checks and balances have been a key part of the institutional fabric that has built strong fiscal states throughout history, as a means of limiting the possibility that a government is run by a narrow unaccountable elite (Besley et al, 2013).

Being part of the UK adds to the checks and balances on both the reserved and devolved powers of the Scottish government. Once these have gone, debates surrounding the role of a second chamber and a constitutional court would surely become salient.

Scotland already has it own fiscal commission to support fiscal forecasting, and if it aspires to rejoin the European Union (EU) post-independence, it is likely that it would have to step in line with the requirements for entry to the euro area (although these seem to be only loosely adhered to and policed for existing members).

How to design the tax system would open a host of new political cleavages and possibly some new constraints for Scotland. As will be covered by other authors in this series, irrespective of the long-term views on the success or otherwise of independence, the post-independence Scottish government would need to act carefully to counter any threat of exit by firms and high-earning individuals.

Since 2015, Revenue Scotland has been a well-established bureaucratic agency for administering tax collection, and there are unlikely to be significant start-up costs in establishing a tax collection system if registered taxpayers under HMRC are simply 'handed over' to Revenue Scotland. Nevertheless, the core challenge goes beyond administrative concerns, since relying exclusively on the coercive and administrative power of the state is unlikely to be enough in itself.

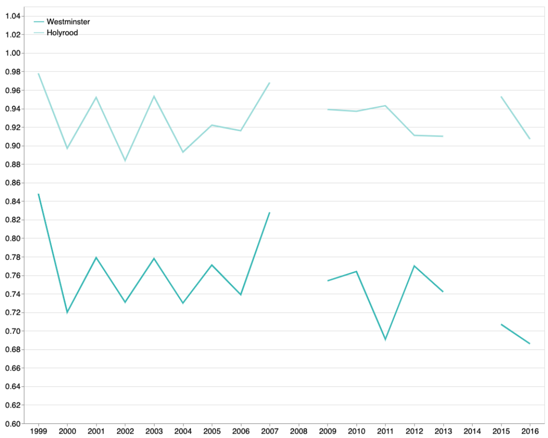
The importance of trust and confidence

Evidence suggests that higher confidence in government is correlated with higher levels of willingness to comply with taxes (Besley, 2020). Fiscal capacity is thus generally complemented by strong norms and values – what is often referred to as 'civic culture'.

Building this confidence comes, in part, from institutional constraints such as checks and balances. States with a record of accomplishment in raising revenues and spending have a reservoir of confidence on which they can draw. For new states taking on new tax-raising powers, this needs to be built. States that are, or have been, dependent on external aid or natural resources have often struggled to build such confidence (Deaton, 2015; Jensen, 2011).

To succeed as an independent fiscal state, Scotland would have to rely on its strong civic culture to bolster the piecemeal process of state capacity. Figure 1 presents data from the Scottish Social Attitudes (SSA) survey, showing that Scots have far more trust in Holyrood than Westminster based on the question 'How much do you trust the [UK government/Scottish Parliament] to work in Scotland's best interests?', of which we take the proportion of respondents answering 'only some of the time', 'most of the time' or 'just about always', relative to 'almost never'.

Figure 1: Scots' trust in the UK government or the Scottish Parliament to work in Scotland's best interests



Source: Scottish Social Attitudes (SSA) survey
Note: Data missing for 2008 and 2014

This has been a fairly stable relationship going back to even the early 2000s, although trust in Westminster has dipped even more since the independence referendum in 2014. Despite lacking data for 2017 onwards, this pattern is also reported to have remained in more recent years.

In line with greater confidence in Holyrood versus Westminster, it is plausible that strong norms and values could bolster an independent Scotland's fiscal capacity in the long run. But this has been based on fiscal powers being located in Westminster. It is arguably easier to build trust when the government is spending money than when it is raising it. Either way, there would be a new era of accountability for Scotland were it to take control of its tax affairs.

Confidence in government and tax morale, both of which enhance fiscal capacity, are further derivative of perceptions of government effectiveness (Torgler, 2003; Daude et al, 2012). If citizens see their taxes being put to fruitful uses, then there should be greater public willingness to comply (Carrillo et al, 2021).

Scotland's more cautious approach out of lockdown is argued to have helped the nation to fare better in terms of excess deaths from the pandemic early in 2021, indicative of a government that can do its job well. Although past performance is not always a good predictor of future performance, the management of Covid-19 by the Scottish government may provide some insight as to whether an effective state could emerge from independence, something that could be leveraged in building a strong fiscal state.

Conclusion

One of the big changes following Scottish independence would be taking responsibility for raising tax revenues. When a country needs to raise 40% of GDP in taxation to support its spending ambitions, there are considerable administrative fiscal challenges, which are untested for Scotland under current arrangements. By being part of the UK fiscal state, like any other constituent part of the UK, these issues are dealt with by Westminster at present.

How Scotland handles debates about the design of tax systems would also be a new challenge for the political economy of Scotland, with the degree of progressivity in the tax system and the structure of business taxation having to be resolved.

This would be key if Scotland wished to evolve a different model for the role of the state, with more generous social provision. Whether it would be able to replicate the generous corporate tax policies that Ireland and Luxemburg have evolved, while aspiring to join the EU, is a further key issue.

It remains unclear whether the implications for tax policy will become central debating points in any referendum, should one transpire. How the fiscal capacity of the UK, as currently constituted, transfers tax powers to a newly independent Scotland would also be an important question. No successful state, large or small, can neglect the exigencies of taxation if it is to serve its citizens effectively

Public purse.

With higher levels of public spending but lower tax revenues than the UK average, Scotland would likely have a large budget deficit were it to become independent, which may make spending cuts or tax rises necessary. The long-term fiscal outlook would depend on the performance of the Scottish economy.

/ David Phillips /

The state of Scotland's public finances was a major issue in the 2014 referendum, with the UK government and Scottish government painting starkly different pictures, and producing very different projections for the future. Scotland's public finances and the implications for independence remain contentious issues and will almost certainly be a significant point of discussion in any future referendum campaign.

Scotland's public finances matter because they would have a key bearing on the tax and spending choices open to an independent Scotland. Scotland currently receives much higher levels of public spending but contributes slightly less tax revenues per person than the UK average. For example, during the period between 2014/15 and 2019/20, spending averaged £1,550 (or 12.3%) higher per person in Scotland than the UK average, while revenues were £325 (or 2.8%) lower per person. As a result, the implicit Scottish deficit – the gap between spending and revenues – averaged 9.2% of GDP, compared with 3.1% of GDP for the UK as a whole during this period.

This pattern looks set to persist and means that if Scotland were to become independent, it would likely be faced with the task of dealing with a large budget deficit, making spending cuts or tax increases necessary in its first five to ten years to get it down to more manageable levels. The longer-term outlook would depend crucially on how the post-independence Scottish economy performed – faster growth, while easier to promise than deliver, could in principle more than offset the loss of fiscal transfers from the rest of the UK.

What do we know about the current position of Scotland's public finances?

Despite devolution, the majority of Scotland's tax revenues and a hefty part of its public spending is pooled with the rest of the UK. This means that there is no overall Scottish budget deficit or surplus, or accumulated debt. Instead, both deficits and debts are subsumed within wider UK public sector deficits and debts, which taxpayers across the whole of the UK are responsible for servicing.

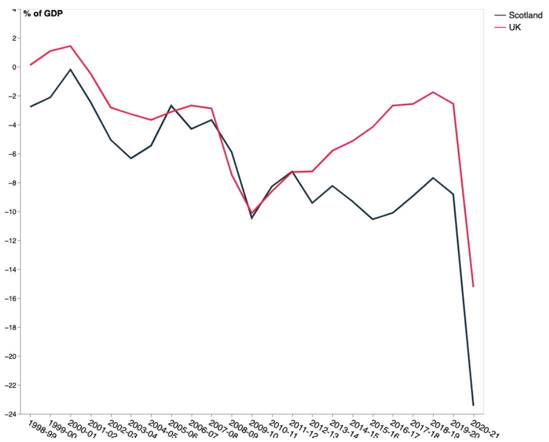
Nevertheless, estimates of Scotland's deficit/surplus are produced by the Scottish government in its Government Expenditure and Revenue Scotland (GERS) publication. This uses both data on actual revenue and spending, where available, and estimates produced from various data sources, where not, to estimate the overall revenues raised in Scotland and public spending undertaken in or to benefit Scotland (Scottish Government, 2021). The latter includes a share of spending deemed to benefit the whole of the UK, including Scotland, such as defence spending, foreign affairs and aid spending, and servicing of the national debt.

From these revenue and spending estimates, figures for Scotland's implicit budget deficit or surplus can be calculated and compared with those for the UK as a whole.

the first year of the Covid-19 pandemic. This shows that for most of the period since devolution, Scotland's implicit budget deficit has been a higher fraction of GDP than for the UK as a whole (see Figure 1).

This has been particularly true since 2014/15, since when a combination of lower prices and production and higher costs, as well as lower tax rates, has reduced North Sea oil and gas revenues (Office for Budget Responsibility (OBR), 2021). For example, in the period between 2014/15 and 2019/20, the implicit Scottish deficit averaged 9.2% of GDP, compared with 3.1% of GDP for the UK as a whole. In 2020/21, deficits are estimated to have peaked at 23.5% and 15.2% of GDP, respectively.

Figure 1: Net fiscal balance, Scotland and UK, 1998/99 to 2020/21



Source: GERS, 2020-21; OBR Economic and Fiscal Outlook, October 2021
Notes: Net fiscal balance for Scotland is based on a geographic share of North Sea oil and gas revenues. Figures for 2020/21 include estimates of the cost of writing off Covid-19 business loans, which were unavailable when the GERS report was being compiled, but were provided by the OBR in its October 2021 Economic and Fiscal Outlook report. The Figure allocates a population share of these loan write-offs to Scotland. Negative numbers are budget deficits, positive numbers budget surpluses.

Scotland's higher implicit deficit is driven largely by public spending being higher than in the UK as a whole. For example, between 2014/15 and 2019/20, spending averaged £1,550 (or 12.3%) higher per person in Scotland than the UK average.

In turn, this was driven by the relatively generous funding the Scottish government receives via its block grant from the UK government to pay for devolved services such as health, education, local government, transport and housing. This is around 30% more than is spent on comparable services in England (Paun et al, 2021; Phillips, 2021a). Revenues averaged £325 (or 2.8%) lower per person than the UK average over the same period.

Two further things are worthy of note:

First, Scotland is far from the only part of the UK with a large implicit budget deficit. Indeed, similar estimates from the Office for National Statistics (ONS) suggest that Wales, Northern Ireland and the North of England all have larger implicit budget deficits than Scotland. Fiscal transfers from areas with lower needs or higher revenue-raising capacity to areas with greater needs or lower revenue-raising capacity are normal within countries (Dougherty and Forman, 2021). Scotland does stand out from the other parts of the UK with large implicit budget deficits though: the other areas are poorer, with much more of their deficits explained by low revenues than in Scotland's case (Phillips, 2021b).

Second, the figures are estimates and subject to both statistical margins of error, and more general conceptual criticism. On the former, there is little reason to believe errors would systematically bias estimates of Scotland's deficit one way or the other. Building on the pioneering work of Jim and Margaret Cuthbert, significant improvements to the construction and transparency of estimates have been made (Cuthbert and Cuthbert, 2005; Roy and Spowage, 2021). In addition, the estimates' status as National Statistics means they have been independently assessed as being based on sound methods and produced free from political interference.

On a more conceptual level, some have criticised the 'benefit' approach taken, arguing that allocating Scotland a proportion of spending taking place elsewhere in the UK (for example to pay for the UK parliament in Westminster) or the world (such as defence and overseas aid) is inappropriate for assessing what the finances of an independent Scotland would be for two reasons.

First, different choices could and would be made on these areas of spending in an independent Scotland. Second, if more of that spending took place in Scotland, it would boost the economy and hence tax revenues, although even under generous assumptions such effects would not change the fundamental picture (Sustainable Growth Commission, 2018). But that is not the primary purpose of the GERS publication: instead, it is to estimate spending, revenue and Scotland's implicit budget deficit under current institutional arrangements.

What would be the short-term position of the public finances for an independent Scotland?

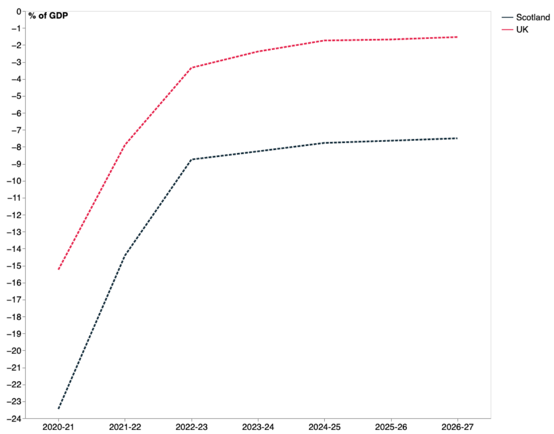
There are two key steps to answering this question:

- First, do the historic GERS figures provide a guide to how Scotland's public finances may evolve in the future, at least in the short term?
- And second, what implications would GERS-based figures have for an independent Scotland?

On the first question, the future is inherently uncertain, not least for the public finances, where forecasts even just two or three years out are subject to wide margins of error (OBR, 2021). But forecasts still provide a useful central prediction on which projections of the future evolution of Scotland's public finances can be based.

Figure 2 shows the OBR's forecasts for the deficit of the UK as a whole and projections for Scotland based on these forecasts and GERS figures, for the period 2021/22 to 2026/27. The Scottish projections assume revenues from North Sea oil and gas follow OBR forecasts, onshore revenues change at the same percentage rate per person, and spending changes at the same rate per person in either cash terms (for spending items that are largely devolved), or percentage terms (for other spending).

Figure 2: Projected net fiscal balance, Scotland and UK, 2021/22 to 2026/27



Source: Author's calculations using GERS 2020-21 and OBR, Economic and Fiscal Outlook, October 2021

Notes: Spending projections are made separately for spending items that are largely devolved (public and common services; public order and safety; agriculture, forestry and fisheries; transport; environmental protection; housing and community amenities; health; recreation, culture and religion; education and training; accounting adjustments) and other spending items (international services; public sector debt interest; defence; enterprise and economic development; science and technology; employment policies; social protection; European Union (EU) transactions). The former items are projected forward assuming the same change in spending per person as across the UK as a whole, but holding population fixed rather than accounting for projected population changes. This is akin to how the Barnett formula used to allocate spending to the devolved governments works (Cuthbert, 2020). The latter are projected forward at the same percentage rate per person, accounting for projected population changes.

The UK budget deficit is forecast to decline significantly (see Figure 2), as temporary Covid-19 related spending (such as the furlough scheme) ends, the economy bounces back from lockdowns, and a range of tax increases comes on stream (Emmerson, 2021).

If Scottish revenues and spending track these UK-wide forecasts, Scotland's implicit budget deficit would also fall. But it would remain significantly higher than for the UK as a whole: 7.5% of GDP in 2026/27, compared with 1.5% for the UK as a whole. Scotland's implicit deficit of £16.3 billion in that year would amount to around £2,975 per person, compared with a UK-wide figure of £640 per person (and a rest-of-the-UK figure of £440 per person).

What would these sorts of figures imply for Scotland if it were to become independent in the next few years?

To some extent this would depend on the 'independence deal' negotiated. As highlighted above, the GERS figures allocate a population-share of UK government debt interest payments to Scotland. The projections are therefore most relevant if Scotland were to be responsible for paying a population share of existing UK debt servicing costs post-independence.

The Sustainable Growth Commission set up by the Scottish National Party (SNP) thought that Scotland should make a contribution to servicing historic UK government debts, in order to secure co-operation from the UK government in other important areas needed for an orderly transition to independence (Sustainable Growth Commission, 2018).

The UK government made it clear that it would expect such a contribution and the Scottish government accepted this, at least in principle, in the 2014 independence referendum campaign (Scottish Government, 2013; HM Treasury, 2014). On the other hand, others have argued that because accrued debt would legally be the responsibility of the continuing UK government – and to reflect the large revenues generated for the UK government from North Sea oil and gas in the 1980s – Scotland should not contribute at all (Cuthbert and Cuthbert, 2014).

Even if we exclude all debt interest costs, Scotland's deficit would still be around 6% of GDP in the middle of the 2020s, based on current forecasts. Continued deficits of that level – let alone the higher levels expected if Scotland had to contribute to existing UK debt servicing costs, as seems likely – would not be sustainable (Pope and Soter, 2021).

Reducing the deficit would require some combination of cuts to public spending or increases in taxation over the first decade of an independent Scotland. This was again recognised by the SNP's Sustainable Growth Commission, which proposed cuts to defence spending, unspecified 'efficiency savings' and holding growth in other spending down to 1% less than growth in GDP for a decade. This would almost certainly imply cuts to some services, and difficult choices for many others (Sustainable Growth Commission, 2018; Phillips, 2018).

It is also worth noting that small, economically developed countries – which is what an independent Scotland would be – tend to run smaller budget deficits than larger countries (Emmerson and Stockton, 2019). This may reflect the fact that smaller countries are more exposed to external and sectoral shocks, and perhaps because of this and their smaller overall debt markets, generally pay higher rates of interest than bigger countries, making smaller deficits desirable (Pope and Soter, 2021; Armstrong and Ebell, 2013). This could mean that an independent Scotland would want to reduce its deficit further than assumed by the Sustainable Growth Commission, requiring further spending restraint or tax rises.

On the other hand, one might be tempted to conclude that low interest rates and experience during the pandemic mean than an independent Scotland need not be overly worried by a large budget deficit. But there is a difference between borrowing large amounts on a continuing basis, and borrowing temporarily to address a crisis, with plans to reduce that borrowing subsequently.

Interest rates would at some point rise without a credible plan to reduce the budget deficit. And one reason why interest rates in the UK and other developed countries have remained so low is that central banks have, in effect, bought much of the newly issued debt. Because an independent Scotland would take some time to set up and establish its own central bank and currency, this option would not be immediately available (Tetlow and Soter, 2021).

What role could economic growth play in improving Scotland's public finances?

One way to increase tax revenues and reduce Scotland's budget deficit without cutting spending or putting up tax rates would be if the economy grew more quickly – with the added benefit that people would also get to keep more money to spend themselves. But how likely is it that faster growth would allow spending cuts or tax rises to be avoided?

Potential effects of independence on the economy are covered elsewhere in this series. It is clear, however, that independence would create a number of economic challenges in the short term that might have a negative effect on the economy, reducing rather than increasing tax revenues. For example, research suggests that the creation of a harder border between Scotland and the rest of the UK would reduce trade and in turn, GDP.

But the longer-term picture is less clear and would depend on how the Scottish economy and Scottish policy-makers responded to the challenges and opportunities presented by independence.

Trade could be re-oriented away from the rest of the UK and towards other trade partners, including in Europe, much as Ireland did in the late 20th and early 21st century. How feasible this would be and the scale of benefits that could be achieved is uncertain though, with one study suggesting that re-joining the European Union (EU) could only offset a small part of the reduction in trade with the rest of the UK (Huang et al, 2021).

Independence would give the Scottish government additional powers – currently held by the UK government – that could potentially help it to grow the economy by increasing the size of the working age population (most notably via immigration policy), boosting labour force participation and employment rates (for example, through welfare reforms), and improving productivity (for example, through changes in regulation).

Improving productivity would likely be the most important, as productivity growth is the main driver of long-term economic growth, and is where Scotland performs most poorly compared with the other small nations of north-western Europe (Tsoukalas, 2021).

Saying one would develop and implement policies that would boost growth is easier than doing so. And most of the policy ideas the Scottish government had at the time of the 2014 independence referendum entailed increasing spending or cutting taxes, which would increase the budget deficit even if they grew the size of the economy (Phillips and Tetlow, 2014).

But there are undoubtedly opportunities to improve policy in areas that are currently reserved to the UK government, or where interactions between devolved and UK-wide policy cause problems (Tsoukalas, 2021). A less obvious but not unimportant area is taxation, where the UK system is both unnecessarily complex and economically distorting. This is also an example of where the different geography and economy of Scotland implies that a different set of policies would be most suitable than in the rest of the UK (Adam et al, 2013).

Whether an independent Scotland would be likely to implement growth-enhancing policies that would enable it to strengthen its public finances in the longer term is an open question. Surveys showing greater trust in the Scottish government may give it greater ability to take the sometimes politically difficult decisions that growth-enhancing reforms can require. Whether that trust would be sustained post-independence is unclear.

What is clear though is that to avoid higher taxes or lower spending continuing in the longer term, stronger growth would be needed post-independence to offset the loss of revenue transfers from the rest of the UK that Scottish residents currently benefit from ●

MONEY TALKS.

If Scotland were to become independent from the rest of the UK, it would need to decide what currency to use. Options include sticking with sterling, creating a new national currency or joining a monetary union, such as the eurozone.

/ Ronald MacDonald /

Currency issues were central to the independence debate in 2014 when the first referendum on Scotland's future in the Union was held. They continue to cause controversy as discussions about a second referendum gather steam.

The reason is that the choice of currency regime is about much more than simply the denomination of notes and coins that circulate in an economy. In reality, the decision gets to the very heart of the economic foundations of a country.

So what are the key issues surrounding currency options for an independent Scotland? What are the trade-offs and where are the main controversies?

The principal currency options for Scotland

A country's currency regime defines how its currency relates to other countries' currencies. Is the relationship fixed or flexible and how does this affect the operation of monetary and fiscal policy? Currency choice can define the currency regime, but it need not.

A number of currency options were discussed in the 2014 referendum, and these remain the principal choices for an independent Scotland:

- First, an independent Scotland could continue to use sterling – either formally, by being part of a sterling monetary union with the rest of the UK, or informally, which is usually referred to as 'sterlingisation'. The latter is the equivalent of dollarisation, whereby a country aligns its currency to the US dollar. It has close parallels in the form of a currency board.
- Second, an independent Scotland could seek to enter a monetary union with another country, or group of countries, and adopt their currency. The most likely candidate would be to join the eurozone. All of these represent a fixed exchange rate regime.
- Third, by issuing its own currency, an independent Scotland would open up other exchange rate regime options such as a fixed but adjustable peg or a freely floating exchange rate.

Each of these options comes with costs and benefits. Deciding which would be the optimal currency arrangement requires assessing the costs and benefits of the different regimes relative to the underlying macroeconomic structure – the trade balance and fiscal position – of Scotland.

Why is the currency regime issue fundamental to constitutional change?

There are two key reasons why the currency regime is so important in the context of constitutional change.

First, an independent Scotland would have its own distinct balance of payments accounts, which would define its trade and capital transactions with the rest of the world – and these accounts would need to balance (see Hallwood and MacDonald, 2000).

Crucially, the way in which they balance differs depending on the currency regime. For example, with a flexible exchange rate regime, the exchange rate moves to ensure that, say, a deficit on the current account of the balance of payments is financed by a surplus on the capital account.

A key feature of a fixed exchange rate regime is that it commits the central bank of a country to defend the 'peg' and since the exchange rate cannot, by definition, move to ensure the balance of payments balances, this is achieved by changes in a country's foreign exchange reserves.

For example, a deficit on the current account would require a corresponding outflow of foreign exchange reserves to ensure that balance is achieved on the balance of payments. This would require the central bank to run down its reserves to maintain the value of the peg.

The second reason why currency regime choice is important relates to how it affects the banking sector and the ability of a country to run an independent monetary and fiscal policy. We turn to these issues below.

The currency debate in 2014 and now

In the 2014 referendum, the Scottish government's official policy was to remain part of the UK's formal monetary union despite the then Chancellor of the Exchequer, George Osborne, ruling this option out (White Paper, 2013). Uncertainty over the currency regime in 2014 is seen as a significant contributing factor to the outcome of the vote.

Since then, there has been a more expansive debate about currency options. The pro-independence Green Party, for example, favour a separate Scottish currency, as do many in the ruling Scottish National Party (SNP).

The SNP's official policy on currency was restated in the 2018 Sustainable Growth Commission report (SGC). That report argued that the Scottish government no longer needed to press for a monetary union, but that an independent Scotland should simply continue to use sterling post-independence in an informal relationship with the rest of the UK, much as some countries use the US dollar informally.

The form of sterlingisation envisaged in the SGC report is one in which an independent Scotland would have its own (albeit limited) central bank and there would be some, but perhaps not all, commercial banks domiciled in Scotland.

Without its own currency (or the lack of a formal agreement with the UK), the Scottish central bank would only be able to provide limited 'lender of last resort' functions (Armstrong and McCarthy, 2014). This refers to the situation where a bank or other financial institution is unable to obtain the liquidity it needs for its day-to-day operations, or in an emergency, from the interbank market and has to call on the central bank. This turns out to be especially important in the case of the informal use of sterling since, as we shall see below, it will create a key liquidity drain from the financial system.

In a further contrast to 2014, the SGC argues that the informal use of sterling post-independence should be part of a transition to a new separate currency in the future. The creation of this new currency would occur once six specific tests had been satisfied, including the creation of a sustainable fiscal policy and a credible monetary policy. There has been demand within the SNP to move quickly on this transition. In April 2019, delegates at the party's spring conference voted in favour of a new currency 'as soon as practicable'.

But as we shall see, the reality of changing currency regimes is inherently complex and subject to pressures outside the control of policy-makers. Evidence throughout macroeconomic history shows that planning a transition with the expectation that it is entirely in the gift of politicians is unrealistic. The experience of Czechoslovakia in the 1990s provides a timely reminder of this.

What are the economic arguments in favour of using sterling post-independence?

There are a number of reasons why seeking to continue to use sterling post-independence might be favoured. First, there is a transaction cost argument: that continued participation in a sterling zone would minimise the costs of trade with Scotland's main trading partner, the rest of the UK.

Costs arise with a separate currency as people and businesses face conversion costs, as well as uncertainties that come from the value of goods and services changing as exchange rates fluctuate. Such costs are likely to be at their greatest with a floating rate regime, and impart an extra wedge into the costs of trade through the need to hedge the risk of currency movements.

It is possible that a newly minted currency might be more volatile, at least during the early stages. In 2014, such costs were argued to be between 0.5% and 1% of GDP for Scotland – between £500 million and up to £2.5 billion for the higher bound (see MacDonald, 2014).

A further advantage of sticking with sterling would be the avoidance of the costs of setting up a new currency both for the government but also households and businesses (Tetlow and Soter, 2021). Retaining sterling would also avoid a redenomination issue in the sense that the establishment of a new currency at anything other than the implicit one-to-one peg would have implications for the value of sterling-denominated assets and liabilities, such as pensions and mortgages.

One of the key disadvantages of a fixed exchange rate currency regime – such as sterlingisation – is that, in such a set up, the central bank, as we noted above, has to subjugate monetary policy to defend the pegged rate by drawing down (in the case of a deficit), or building up (in the case of a surplus), foreign exchange reserves.

In such a regime, the central bank cannot adjust the exchange rate or interest rate. Clearly, this would limit the ability of an independent Scotland to deal with local economic shocks since flexibility in the exchange rate can provide an external adjustment mechanism and act as a 'shock absorber'.

But if an independent Scotland were able to continue to be part of a formal monetary union with the rest of the UK, it would still have the support of the Bank of England in terms of both its economy and banking system. That would clearly not be the case with the informal use of sterling where the Scottish central bank's monetary policy would simply be tied to defending the fixed exchange rate arrangement and the implicit one-to-one peg.

How robust might a sterling zone be post-independence?

Central to how robust a fixed exchange regime is over time are the economic fundamentals that underpin it.

In 2014, the Scottish government argued that a sterling arrangement would be robust, drawing on research on the idea of 'optimum currency areas' (MacDonald, 2014). These studies posit that countries might be well-suited to a fixed exchange rate regime (including monetary union) if there is a sufficiently high degree of labour and capital mobility between the participating countries, the countries have a high degree of trade with each other and their business cycles align.

But this is only part of the story. Key to understanding how stable a fixed exchange rate regime with sterling is – either formally or informally – also depends on whether such a regime is consistent with the underlying macroeconomic fundamentals in the individual countries themselves, and specifically the fiscal and balance of payments deficits. This is where things arguably get more challenging for arguments in favour of retaining sterling.

Official statistics show that Scotland currently has a structural fiscal deficit – in other words, its public spending is higher than the revenue it generates, for example through taxes. The pre-pandemic (2018/19) fiscal deficit in Scotland was 7.7% (compared with a UK deficit of 1.8%).

In addition, the available data on Scotland's current account position show a net trade deficit in 2020 of around 8.4% of GDP. The net factor income component of the Scottish current account is not available on a continuous basis and the latest data on this series are for 2017 and give an overall current account balance of around 10% of GDP in that year (Scottish National Accounts Programme). Given the net trade deficit was 6.7% in 2017 and that it is unlikely that the net factor income component of the current account will have improved since 2017, it is not unreasonable to assume that the overall current account balance of payments deficit remains in the region of 10% of GDP. The latter deficit has two very important consequences for the financing of government debt and the stability of the banking sector.

Government debt, the banking sector and monetary and fiscal policy

First, and in terms of government debt, a fixed exchange rate and large current account deficit would – over time – be incompatible. This would be starkest with the informal use of sterling where, as highlighted above, an independent Scotland would have to raise foreign exchange reserves to finance the current account deficit. Although in principle such reserves could be borrowed, in practice, financial markets might take a dim view of such an arrangement since it would not be sustainable or credible given the magnitude of the current account deficit.

As other countries' experiences demonstrate, the only sustainable way to preserve the fixed exchange rate relationship would be to run a fiscal surplus (see Tetlow and Soter, 2021). But this would require a significant programme of fiscal consolidation from Scotland's likely initial starting position (with knock-on implications for policy choices post-independence).

In the case of a formal monetary union, the reserve needs of an independent Scotland would be covered by the Bank of England, although that would presumably come at the price of limits on the independence of fiscal policy. Although a formal monetary union arrangement might be expected to be more resilient to such pressures than sterlingisation, there would nonetheless still be a tension in such a system with the incompatability of a fixed exchange rate, an implict one-to-one peg and a large current account defecit.

Of course, financial markets would recognise this. Being forward-looking, international investors might be sceptical that a fixed regime could be maintained without major adjustment, this being especially so given the clear statement in the SGC report that the use of sterling post-independence is a purely transitory relationship.

This would present important challenges for policy-makers:

- they could follow through with potentially politically challenging fiscal consolidation policies to shore-up Scotland's core macroeconomic fundamentals to be consistent with a sterling currency regime or;
- abandon the fixed exchange rate regime and introduce a devalued Scottish currency, which given the size of the current account deficit, noted above, could be very significant indeed.

Even the potential of the second option would see financial markets build a risk premium into the interest rates they would be prepared to lend at. Such effects are likely to be most significant in the borrowing markets for sovereign debt (government borrowing). Any concerns over an independent Scotland accelerating the timetable for any planned introduction of a new currency (intentional or otherwise), would only add to the associated risk premium. The situation would be exacerbated by households and businesses moving assets out of the country.

Liquidity and lender of last resort

The above effects would be important to address in any form of fixed exchange rate system. But a second challenge with sterlingisation is that any balance of payments deficit would see sterling reserves draining out of the system, along with the deflationary consequences of this. But with limited – and finite – inherited reserves, an independent Scottish central bank under sterlingisation would be constrained in how much leeway it would have to combat this.

These issues would be compounded if the Scottish central bank was prepared to offer deposit insurance for Scottish-domiciled banks that would add to the sum needed to support the balance of payments (see Armstrong and McCarthy, 2014). Of course with a formal monetary arrangement these issues would continue to be dealt with by the Bank of England, at the price of compatible rules for the operation of fiscal policy in Scotland.

What this discussion highlights is that crucial to any choice of currency regime for an independent Scotland is not just a recognition of what might 'make sense' from a microeconomic or trade perspective, but also the fundamentals of the macroeconomy.

The continued use of sterling post-independence – either under a monetary union or sterlingisation – would require a strict macroeconomic regime be put in place. This would demand short-term adjustments to Scotland's fiscal and balance of payments position. If not, retaining sterling would be a poor anchor for an independent Scotland.

What about other options?

In thinking about the appropriate currency regime for an independent Scotland, a key lesson is the importance of compatibility with underlying macroeconomic fundamentals – and most importantly, a country's balance of payments position.

In this regard, many economists would argue that a regime more compatible is that of a 'free float'. This is a flexible exchange rate determined by demand and supply of domestic and foreign currencies.

In principle, a flexible exchange rate does not require any foreign exchange rate holdings, although, in practice, countries with a floating regime do hold such reserves. A flexible exchange rate regime would be compatible with the foreign exchange reserves an independent Scotland would likely inherit post-independence.

Such a regime would provide a period of stability for the central bank and treasury of an independent Scotland to build credibility in the operation of fiscal and monetary policies. It would also allow time for foreign exchange reserves to be built up if there was a desire to move to a more fixed form of exchange rate regime in the future.

It is noteworthy that aside from the short-lived European Exchange Rate Mechanism (ERM) experience, since 1973, the UK has operated a flexible exchange rate regime. This regime has absorbed many of the shocks hitting the UK economy since the 1970s, from stagflation through to Brexit and the Covid-19 pandemic.

For a newly independent Scotland with a balance of payments deficit and fiscal deficit, the initial currency depreciation could be steep, with knock-on implications for the value of assets and liabilities denominated in sterling. Issues of redenomination and transactions costs would loom large.

But this currency thistle of redenomination has to be grasped at some point on the journey to Scottish independence. The message of this article is that if Scotland is to become independent, the sooner this is addressed, the better given the way that capital markets operate in a globalised economy

Gaining currency.

Were Scotland to become independent, its choice of currency would be a key decision. Whether the country remained in a formal or informal currency union with the UK, adopted the euro or established a new currency would have significant consequences for the role of a Scottish central bank.

/ Iain Hardie /

The currency choice of an independent Scotland has always involved questions around the role of a Scottish central bank. Recent developments – from the growing economic and political roles of central banks to the expansion of central bank purchases of government bonds – have increased the importance and breadth of this issue.

How do these developments influence the way a central bank might operate in an independent Scotland? How would they affect an independent Scotland's choice of currency?

What is the traditional role of the central bank?

A central bank has broad areas of responsibility. It has several day-to-day routine functions that it undertakes, including providing liquidity for the banking system, currency issue and management, and banking services to the government.

In addition, central banks typically have two main policy responsibilities:

- **Monetary policy:** typically involving the setting of short-term interest rates, but in recent years moving beyond this, with a view to achieving an inflation target.
- **Financial stability:** most importantly as the 'lender of last resort' for the liquidity needs of solvent commercial banks that find themselves short of liquidity. This can also include responsibility for financial supervision to the extent that this is not covered by a separate agency.

What are the central bank options for an independent Scotland?

An independent Scotland would face an important choice about its currency arrangements (MacDonald, 2022). The choice of currency would then have implications for how the country's central bank should be designed and the functions it could undertake.

Under the option of a formal currency union – whether with the rest of the UK or with the European Union (EU) – an independent Scotland would share a central bank with the other member(s) of that union.

The shared central bank – the Bank of England or the European Central Bank (ECB) – would have responsibility for inflation and for lender of last resort activities across the currency area (including Scotland). In the case of the euro area, this would also involve potentially working with local national subsidiaries. Members are represented in the decision-making of the central bank, as on the ECB's Governing Council.

In the 2014 independence referendum, the Yes campaign's proposed policy was for a formal currency union with the UK. No agreement was reached, but the Scottish government envisaged having Scottish representation in the governance of the Bank of England, which would have responsibility for central bank policy in Scotland as well as for the rest of the UK.

A second option – an informal currency union using sterling – was proposed by the Scottish National Party's Sustainable Growth Commission. In this case, there would be no separate Scottish monetary policy, but a Scottish central bank might still be required to undertake a number of functions related to managing the government's accounts and currency reserves. It would also be at the centre of the Scottish payment system.

The Bank of England's role in this case would be less clear-cut; indeed, it may assume no role. Most importantly, the Bank of England's responsibilities towards Scotland in such a scenario would be decided entirely by the authorities in the rest of the UK. In normal economic conditions, it would be unlikely to pay specific attention to Scotland in deciding policy. An example of this can be seen in the United States where the Federal Reserve has no responsibility for economic conditions in Ecuador or Panama – two countries that have informally adopted the US dollar.

To the extent that Scotland's economy is close in nature to the rest of the UK (it is part of what economists call an optimal currency area or OCA), this may not matter for some aspects of central bank policy. In such a situation, for example, and at least in the short term, UK interest rates would be appropriate to Scotland. If the UK is not an OCA, then a central bank setting interest rates only for rest of the UK would not be appropriate for Scotland.

In an informal union with the rest of the UK, a Scottish central bank would not have the capacity to fulfil all of the responsibilities of a central bank to any meaningful extent (Armstrong and McCarthy, 2014). In particular, there would be reduced capacity to act as lender of last resort to the banking system or undertake 'unconventional monetary policy' involving the purchase of financial assets (see below). This is because, while it might be able to build up some reserves to help with this over the long term, ultimately this capacity depends on the ability of a central bank to create (or 'print') the domestic currency. A Scottish central bank could not do this in an informal currency union.

The Bank of England may choose, with the support of UK elected policy-makers, to have some responsibilities – perhaps indirectly – towards an independent Scotland's economy or banking system. An informal currency union does not preclude agreement between two countries about central banking, and the lack of agreement does not prevent any subsequent support.

Central banks often reach agreements between themselves. The UK government participated in the bailout of Ireland in 2010, despite not being a member of the euro area. What these agreements might look like, and the circumstances under which they might be implemented, are uncertain, as is any agreement.

Under the third option – a separate Scottish currency – an independent Scotland would have its own central bank with the full capacity to perform all the functions discussed above. This central bank would be expected to be accountable to the Scottish government and to the Scottish parliament, including with regard to the issues discussed below.

With this option, monetary policy would be set for the needs of Scotland alone, although decisions would have to take account of international influences. Crucially, in contrast to other options, this policy would allow an independent Scotland to create or print its own currency. This enhances the lender of last resort liquidity support available to Scottish banks and the ability to perform unconventional monetary policy, in particular the quantitative easing (QE) that has become increasingly common since the global financial crisis of 2007-09.

How have recent developments affected the potential role of a Scottish central bank?

Even before the Covid-19 crisis, central banking was entering a period of change (Goodhart, 2010). The response to the pandemic and parallel debates around the role of central banks have increased their economic and political importance. This has the potential to increase the range of central bank capacities available were Scotland to have its own currency.

The most important change has been the increased influence of central banks on government borrowing through the buying of government bonds as a part of unconventional monetary policy. Central banks are responsible for monetary policy; governments are responsible for fiscal policy. The separation of responsibility for monetary and fiscal policy is fundamental to present-day central banking. But this separation is never absolute.

Monetary policy, through the setting of short-term interest rates, has always had an influence on governments' borrowing costs. When short-term interest rates are low, these are usually low. When rates are high, this will generally increase the interest rate on government bonds (Baker et al, 2016). Similarly, the economic impact of fiscal policy will influence a central bank's monetary policy decisions. The buying and selling of short-term government bonds has also long been a normal part of monetary policy.

Unconventional monetary policy, most commonly QE, involves central banks seeking to support increased economic activity by buying financial assets, including government bonds. With QE, the lines between monetary and fiscal policy have begun to blur significantly, but in the UK stopped short of 'monetary financing' (McMahon and Macchiarelli, 2020).

Monetary financing is when a central bank directly finances the government's fiscal deficit – the gap between public spending and income from tax and other revenues. Permanent monetary financing is expected to cause inflation. It is, for example, banned under the treaty that established the ECB.

But recent research from the International Monetary Fund (IMF) argues that modest monetary financing in countries with a track record of responsible economic policies does not raise inflation expectations (Agur et al, 2022).

During the Covid-19 crisis, central bank support for government borrowing increased markedly, even when compared with previous episodes of QE. In the UK, for example, government borrowing was at its highest since the Second World War.

Some economists argue that QE during this time made the Bank of England effectively the 'buyer-of-last-resort' (albeit by matching government issuance with buying in the secondary market rather than directly financing the government).

Investors in the market for UK government bonds (gilts) have doubted the government's ability to borrow to finance its needs in this period without the Bank of England buying gilts (Financial Times, 2021). From March 2020 until November 2021, the Bank of England purchased over £400 billion of gilts, almost exactly matching the UK government's net cash requirement – a measure of its borrowing requirement – month by month.

The Bank of England's actions are a temporary response to an unprecedented health and economic emergency. Additional gilt purchases can stop as monetary policy dictates, and the Bank of England retains the option to sell the gilts it holds over time, or not to buy any more as those they hold are repaid.

This partly underpins the argument that this is not monetary financing, as it is not permanent. But, 13 years on from the start of QE, the Bank of England has remained a significant holder of gilts and QE will continue to be part of central banks' policy tool kit.

In a formal currency union, QE can work across member countries. During the pandemic, the ECB has created euros to purchase members' government debt, keeping borrowing costs unusually low. An informal currency union would not have any such arrangement, and a Scottish central bank would have no capacity to create sterling to support Scottish government borrowing (and therefore expenditure).

This is not to say that an independence Scotland would be unable to borrow at all, but we cannot be confident as to how much it would be able to borrow in an informal currency union.

A new Scottish currency would mean that Scotland would have a central bank able to create money to purchase government debt, as many governments have done during the pandemic.

Policy would still have to focus on inflation, and the value of the currency and would depend on the new central bank establishing a reputation for policies perceived as responsible (Besley and Dann, 2022). Once this is achieved, a Scottish currency is likely to allow the greatest crisis-related government expenditure.

How else are central banks politically important?

Are there other policy options for an independent Scotland's central bank? Recent developments suggest that central banks are increasingly considering policy areas that would be important for an independent Scotland: inequality, house prices and climate change.

There remains a debate among central bankers themselves as to the extent to which they should be involved in such issues (Tucker, 2018). The concern here is not that debate, but the implications for Scotland's currency options.

With its own currency, Scotland would decide whether (and, if so, how) these issues should be part of its central bank's concerns. In a formal currency union, these debates would be part of a discussion across all countries. In an informal union, the Bank of England and the Westminster government would decide.

Inequality

There has been a debate almost since QE was introduced as to its distributional consequences. QE pushes asset prices higher, as is in part its intention, and this price appreciation favours the holders of these assets.

But financial assets are held disproportionately by the wealthy and, as a result, QE risks increased wealth inequality. Against this, by supporting economic activity, the incomes of the poorest, who are most vulnerable to recession, are supported, with positive implications for income inequality (Bunn et al, 2018).

Inequality has implications for the performance of an economy, justifying central bank attention, but the nature and extent of central bank actions on inequality are also a political issue.

Housing

In February 2021, the New Zealand government required its central bank to consider house prices in its decisions (Powell and Wessel, 2021). This was prompted by widespread concern about rapidly rising property prices.

The debate around this move is linked to a broader debate about whether central banks should act to address asset price inflation more generally, including seeking to address bubbles in the equity market, for example. The Bank of England already considers house prices in the context of banking regulation and financial stability, and the Reserve Bank of New Zealand may do similarly. But going further, a policy focused on the rest of the UK would have important consequences in Scotland.

Climate change

ECB president Christine Lagarde has been particularly vocal about the need for central bank policy to consider climate change. Arguments for doing so include risks to financial stability from the damage caused by rising temperatures. Central banks have powerful tools in this regard. For example, climate-related risks to banks and insurance companies can be regulated more aggressively.

In addition, as part of QE, many central banks buy bonds issued by companies, supporting their prices. Excluding fossil fuel companies from such programmes could have a significant impact on their borrowing costs.

No action would also be an influential decision. If central banks buy an equal share of the corporate bonds in the market, heavy emitters of greenhouse gases benefit most, as they issue higher volumes of bonds.

Conclusions

A Scottish central bank would not only be key to monetary policy but could also be involved in some of the most important political issues that an independent Scotland would face. Whether Scotland decides on these issues, or if decisions are taken elsewhere, is closely tied to its currency choice.

An independent Scotland would need an independent central bank, regardless of the functions that the choice of currency allows. This would be a requirement for market participants to have confidence in policy, especially if Scotland has its own currency.

Yet, central bank independence is never absolute. Decisions by – and about the institutional design of – central banks are inherently political, rather than simply technical, because they have distributional consequences. The decision on what powers the central bank should have, and therefore the currency choice, is as much political as economic

Risks and opportunities.

Ahead of the 2014 independence referendum, businesses in Scotland were typically focused more on the risks posed by uncertainty than on potential opportunities. Circumstances have changed – most notably the UK's exit from the European Union – which may lead to different assessments in a future vote.

/ Brad MacKay /

Navigating uncertainty is part and parcel of leading a business. Minimising risks and maximising opportunities come with the territory. But constitutional change raises the prospect of institutional uncertainty of a different magnitude to that of day-to-day market competition.

That is because institutions – whether they are regulatory regimes, legal frameworks, fiscal policies, or trade agreements – set the 'rules of the game' for business. Firms configure themselves to optimise performance within them. But unlike a single fiscal, legal or regulatory change, a referendum on independence brings the uncertainty of possible wholesale change.

Ultimately, the decisions that business leaders make at an individual firm level – whether to invest, divest, consolidate, grow, and whether to enter or exit a business, market, sector or industry – cumulate and amplify to have a profound impact on local, regional and national economic performance.

How business leaders make sense of such uncertainties, identify the risks and opportunities that they present, and ultimately act at a micro level has implications for short- to medium-term prosperity at a macro level. Establishing how they make decisions under conditions of constitutional uncertainty is therefore critical to understanding wider economic performance and prospects.

How do business leaders make decisions under conditions of uncertainty?

Decision-making under conditions of uncertainty generally, and political uncertainty specifically, has been an area of economic inquiry for many years. Research has often focused on pro-active versus uncertainty avoidance strategies when there is policy or regulatory uncertainty. Depending on whether such decisions are viewed as an opportunity or risk, investments might be delayed or pre-empted (Bernanke, 1983; Bloom et al, 2007).

Evidence from studies of responses to regulatory uncertainty and changes of policy have been mixed (Doh and Pearce, 2004; Dutt and Joseph, 2019). When facing a significant policy or regulatory change, many businesses adopt a 'wait-and-see' position (Holburn and Zelner, 2010; López-Gamero et al, 2011; Marcus and Kaufman, 1986; Yang et al, 2004).

But other research indicates that this is not always the case, particularly where decision-makers identify a 'first-mover-advantage' – whereby a firm can benefit by acting before its competitors (Aragón-Correa and Sharma, 2003; Carrera et al, 2003; Hoffmann et al, 2009; Marcus et al, 2011). Some businesses may also come under pressure from external parties – such as investors and financial analysts – who pressure decision-makers into addressing uncertainties that may affect future performance (Wiersema and Zhang, 2011).

Some research also shows that strategies to deal with uncertainty will vary depending on whether the uncertainty is likely to yield slow continuous change, rapid high velocity change or uneven, discontinuous change (Doh and Pearce, 2004).

Constitutional uncertainty falls into the last category as it brings the prospect of disruption to multiple institutions simultaneously and change to the rules of the game for business (good or bad).

Suffice to say, there is relatively limited research on the impact of independence movements on business behaviour. Seminal studies of the economics of secession have focused on such issues as the economic determinants of secessionism, the political economy of secessionism and regional economic inequalities (for example, Collier and Hoeffler, 2006; Griffiths, 2014; Horowitz, 1985; Sambanis and Milanovic, 2001; Sorens, 2005).

Studies of business more specifically have tended to focus on voting preferences. They note that large businesses tend to oppose significant constitutional change, while smaller businesses are more inclined to support it (Dion, 1995; Gagnon and Lachapelle, 1996; Lange, 1998; Lynch, 1998; Medina and Molins, 2014).

Yet others have argued that the size of a business is 'merely a surrogate for several things poorly understood' (Darnall and Edwards, 2006). For example, research shows that other characteristics, such as ownership structure, may have greater explanatory power of why certain strategies are adopted over others in specific circumstances (Darnall and Edwards, 2006; Mascarenhas, 1989).

The Scottish independence referendum and business

The 2014 referendum on Scottish independence provided an opportunity to investigate how business leaders make sense of the uncertainties created by such votes.

One study – based on interviews with 75 leaders of businesses with a significant economic footprint in Scotland – found that around 90% reported uncertainty associated with the independence debate (MacKay, 2013).

The interviewees represented sectors such as business services, electronics and technology, energy, engineering and manufacturing, financial services, food and drink, and life sciences. They were asked whether they faced any uncertainties related to the constitutional questions, if they perceived the independence referendum to be an opportunity or a threat, and, as a proxy for decision-making, whether they were making contingency plans for different outcomes.

In addition to the reports of overall uncertainty, in 2014, these business leaders were more readily able to identify risks than opportunities. The risks were most pronounced in large, publicly traded companies with head offices in Scotland, and for which trade with the rest of the UK was important.

For these companies, the prospect of being regulated in a jurisdiction outside where most of their business took place, the question of what currency would be used, complexities around tax, employment and access to the European Union (EU) market were most commonly cited.

It was these businesses, often prompted by pressure from shareholders or customers, that were most likely to be putting in place contingency plans (for example, moving their 'brass plate' elsewhere or setting up alternative supply chains).

Participants from large and medium-sized companies that were privately owned were also likely to emphasise the risks of independence over opportunities. But without the pressure of being publicly traded, they did express a greater willingness to absorb any short- to medium-term downside risks. Partnerships, given their management structures and diversity of views, were less likely to express strong views either way.

Participants from large subsidiaries of global companies were most likely to emphasise their experience of working across multiple jurisdictions. Such companies were more likely to rely on business continuity plans already in place than to initiate contingency planning specifically related to the independence debate.

For these participants, decisions about whether to invest, divest, consolidate or grow, and whether to enter or exit a business, sector or industry in Scotland were closely connected with the reasons that they were invested in the first place. For these participants, the overall business and trading environment that emerged following a referendum vote was also an important consideration.

Participants from businesses whose customers, labour and supply chains were primarily in Scotland or global were more sanguine about the prospects of independence than those that had significant trade with the rest of the UK.

Even within industries such as financial services, variations in participants' responses were divided along such lines. For example, a hedge fund headquartered in Scotland but with a global customer base and investment profile may have been less concerned about the risks posed by the prospect of independence than a retail bank or insurer whose customers were primarily in England.

Half of the participants who took part in the study were unable to identify additional opportunities that independence might bring beyond those already available.

Of those participants that did identify opportunities arising from the constitutional debate, only 10% emphasised opportunities over risks. These participants tended to be from medium-sized businesses with a significant proportion of their trade being either in Scotland or global.

Opportunities tended to be more specific to their business, such as the prospect of dispensing with an adverse licensing fee controlled by the UK government or the possibility of greater research and development support from an independent Scottish government, rather than more general opportunities that might arise from an independent Scotland. In these instances, the opportunity to be able to influence government in a smaller country was frequently cited.

The interviews conducted for this study add granularity to survey findings conducted at the same time. Other surveys in 2013 and 2014 – conducted in partnership with the Scottish Chamber of Commerce – found that the main uncertainties listed by the 759 respondents included business and personal taxation, regulation, currency and Scotland's relationship with the EU (Bell and McGoldrick, 2014).

Half of the participants in the study were able to identify some associated opportunity with independence, including policies more appropriate for Scotland, improved business support from government and close identification with the Scottish brand.

But strikingly, only 4% of respondents identified business growth as an opportunity, and 47% couldn't identify any opportunities at all. Of the 24% of business that have a risk register, only about half listed the constitutional question, and these businesses tended to have their trade in the rest of the UK or EU.

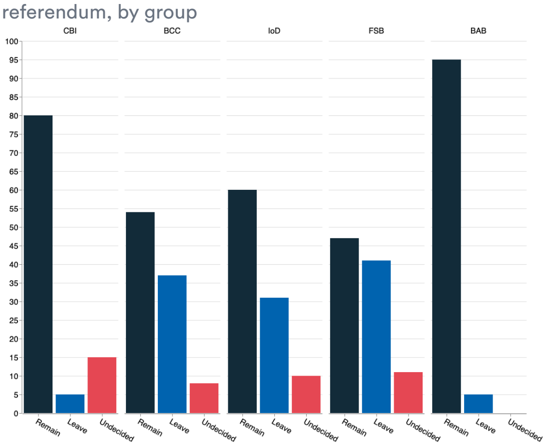
Indeed, along similar lines, analysis of a longitudinal panel of business investment in 3,589 Scottish firms in the lead-up to the 2014 referendum found that listed firms, firms on the border with England, firms that are financially constrained or whose investments are likely to be irreversible had greater sensitivity to the political and policy uncertainty generated by the independence debate (Azqueta-Gvaldon, 2020).

Echoes of the Scottish independence referendum in the Brexit debate

Findings from the study of business attitudes and perceptions during the Scottish referendum shed light on the responses to industry-led surveys ahead of the referendum on the UK's membership of the EU in 2016 (see Figure 1).

Surveys of industry bodies with membership drawn from predominantly larger businesses (such as the Confederation of British Industry) tended to find more negative attitudes to leaving the EU than those with membership drawn from smaller firms.

Figure 1: Business attitudes towards the 2016 EU referendum, by group



Source: Surveys conducted by the Confederation of British Industry (March 2016); British Chambers of Commerce (May 2016); Institute of Directors (May 2016); Federation of Small Businesses (September 2015); British American Business (March 2016).

Digging into a survey of 2,231 firms conducted by the British Chambers of Commerce in May 2016 helps to explain why.

Businesses exporting to the EU were much more likely to be in favour of remaining part of it (62.1%), while that figure dropped to 46.7% for those that only export to the rest of the world. Only 30.7% of firms that sell to the EU were biased towards leaving, while that figure increased to 50.1% for those that only export to the rest of the world.

Of non-exporters, 42.8% were inclined to vote to remain in the EU, while a slightly higher 46.4% expressed support for leaving. It was also non-exporters who were most inclined to respond that they didn't know whether to opt for remain or leave, at 10.2%.

Evidence from the Brexit debate supports the findings reported here: that it is not so much the size of the business that is important, but how they are structured and where they have significant business activity.

What can we learn from Brexit for any future debate on Scottish independence?

In January 2021, the UK exited its transitional membership of the EU's customs union and single market. While the effects of the Covid-19 pandemic have complicated assessing the impact of Brexit on UK economic growth, exports and imports between the EU and UK fell sharply in 2020: by 14% and 19% respectively. This was even more pronounced between the fourth quarter of 2020 and the first quarter of 2021, with exports falling by 18% and imports by 25% (Ward, 2021).

Evidence from the Bank of England and the National Bureau of Economic Research suggests that the Brexit process, and uncertainty about future outcomes, have also depressed business investment and productivity. This has resulted from, amongst other factors, the culmination of a multitude of firm-level decisions.

The reasons for this drop will become clearer over time, but even with the UK-EU Trade and Cooperation Agreement (TCA) between the EU and UK covering goods (but not services), it has created border frictions.

Indeed, according to analysis by the Office for Budget Responsibility (OBR), in the longer term, both imports and exports will be around 15% lower than had the UK remained an EU member. Similarly, productivity will be about 4% lower due to non-tariff barriers compared with if the UK had remained an EU member.

Given that many new trade agreements between the UK and countries outside the EU largely replicate the agreements that the UK had as an EU member, forecasts suggest that, as with the UK-Japan

Comprehensive Economic Partnership, these will be largely immaterial for GDP growth (OBR, 2021). Businesses' perceptions about the impact of leaving the EU on market access have therefore largely been borne out in practice.

Wider economic performance is based, in part, on business leaders' perceptions and the decisions that stem from them. The survey findings reported here are largely consistent with research showing that uncertainty can influence business decision-making, as investments are deferred until future outcomes become clearer.

It's not necessarily all bad news either. Government provision of tax incentives and the need to upgrade assets neglected due to the uncertainty created by the Brexit process has led economists to forecast a strong domestic recovery for business investment following the transition period to a new UK-EU trading relationship (Romei, 2021). This suggests that the deferral of business investment due to political uncertainty can rebound once such uncertainty is resolved.

Yet Brexit also shows that the realities of increased complexity of exporting to European countries, even with goods covered by the TCA – the non-tariff barriers – are likely to dampen exports. This is because the costs for businesses begin to limit the benefits and opportunities of trading in some areas.

With the end of the Brexit transition period, compliance with relevant 'rules of origin', EU standards, regulatory checks and differing authorisations between EU countries (which 'passporting rules' once circumvented) all add costs to businesses.

As the implementation of the TCA comes into force in 2022, with full border checks in the UK, and businesses have had time to adjust with reconfiguring supply chains and labour, the full impact of the Brexit will become clearer. Some initial surveys of business leaders suggest that in the short term, a third of businesses that trade with the EU have experienced declines in trade (Institute of Directors, 2021).

Indeed, recent data published by the world trade monitor appear to show British exports underperforming the rest of the world (CPB, 2022). This has led the OBR to remark in their economic and fiscal outlook that trade flows of exports and imports were 'lagging behind the domestic economic recovery', and they suggest that 'Brexit may have been a factor' (OBR, 2022, p. 62).

The experience of Brexit gives an indication of some of the challenges and opportunities that might arise for business and the economy in the event of a Scottish vote for independence from the UK. While the UK is and will continue to be Scotland's largest trading partner irrespective of independence, the prospect of rejoining the EU presents another complex dimension to the debate.

Conclusion: the past as prologue?

Research looking at business perceptions and decision-making in the lead-up to the referendum on Scottish independence in 2014 shows that factors such as ownership structures, location of key markets, as well as those of labour and supply chains were key determinants in how participants made sense of the uncertainties presented by the constitutional debate (MacKay, 2013). These also contributed to whether they perceived there to be opportunities or risks associated with independence.

With a Scottish population of around 5.5 million people, and a population of approximately 61.5 million in the rest of the UK, large businesses in Scotland were likely to have 80% or more of their UK business outside Scotland. Government data also routinely suggest that 60% or more of Scottish exports at present go to the rest of the UK, largely reflecting the difference in the size of the respective markets.

The factors shaping perceptions of uncertainty, and whether uncertainty presents opportunities or risks are unlikely to be significantly different in a second referendum. Business behaviour and decisions around whether to invest, divest, consolidate or grow, and whether to enter or exit a business, market, sector or industry are clearly more nuanced than simply attributing such outcomes to the size of a business.

Some circumstances in Scotland have clearly changed since 2014, particularly with Brexit, but also in terms of the sectors attracting investment. Given these changed circumstances, how factors shaping perceptions of uncertainty interact might conceivably lead to different perceptions of opportunity and risk in a second referendum.

It is likely that the rest of the UK will continue to be Scotland's most important trading partner for the foreseeable future. The UK economy, it is important to emphasise, is highly integrated. The impact that Brexit may have on business attitudes towards the opportunities and risks posed by the prospects of a second referendum remains to be seen. It is likely that patterns would not be significantly different.

In the short term, listed firms and firms with significant trade in the rest of the UK will be most anxious and prone to defer investment or move part or all of their operations in the event of a 'yes' vote. Subsidiaries of multinational companies, privately held firms with the majority of their trade in Scotland, firms with global markets or those that see growth opportunities in Europe might be comparatively more relaxed.

The lessons from the Brexit negotiations and the challenges and opportunities we have experienced throughout the process will also undoubtedly play an important role in shaping the views of business ●

Border disputes.

If Scotland were to become an independent country, there would be a new international border with the rest of the UK. The additional costs that are inevitably created by borders would affect trade, making it harder for Scottish firms to do business with the rest of the UK.

/ Thomas Sampson /

Borders between countries create additional costs for businesses, which lead to lower levels of trade. As the rest of the UK accounts for over 60% of Scotland's exports, the Scottish economy would be vulnerable to an increase in border costs should it become independent. But there is considerable uncertainty over how substantial the economic effects of introducing a border with the rest of the UK would be.

Focusing only on changes in international trade, independence would be expected to have a negative effect on the Scottish economy because of higher border costs. And rejoining the European Union (EU) would not necessarily offset the border costs of independence. This is because Scotland currently trades around four times more with the rest of the UK than it does with the EU.

How do borders affect trade?

International borders create barriers to doing business that economists refer to as 'border costs'. These result from many factors, including import tariffs, customs 'red tape', regulatory differences between countries, limits on market access for services, restrictions on labour mobility, and cultural and social differences that reduce international communication. Consequently, trade costs between countries are higher than between regions within the same country (Anderson and van Wincoop, 2004).

Research shows that border costs are economically important and have large negative effects on international trade (McCallum, 1995). One study estimates that the border between the United States and Canada may increase trade costs between the two countries by 48% (Anderson and van Wincoop, 2003).

International agreements such as free trade areas, customs unions or the EU's single market reduce the trade costs caused by international borders, but they do not eliminate them entirely. Even within the EU, many economic policies are country-specific – including taxes, labour market laws and regulation of many service industries – which creates border costs.

Analysis of goods trade finds that border costs between EU countries are 13% lower than those between countries where at least one of the partners is not a member of the EU. At the same time, border costs within the EU are still 23% higher than trade costs between US states, showing that there are border costs even within the single market (Comerford and Rodriguez Mora, 2019).

Evidence that EU membership reduces border costs explains why most economists expect Brexit to make the UK worse off (Sampson, 2017). The Scottish government's own Brexit analysis argues that leaving the EU will reduce the nation's GDP by increasing border costs between it and the EU (Scottish Government, 2018).

What is Scotland's pattern of trade?

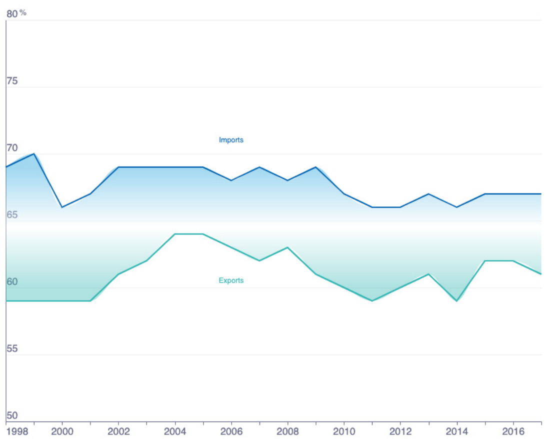
A challenge when studying Scotland's economy is the lack of fully comprehensive trade data. Unlike independent countries, Scotland does not collect detailed statistics on its external trade. Export Statistics Scotland – produced by the Scottish government – provides useful survey-based data about onshore Scottish exports, but import data are relatively sparse. Measuring Scotland's trade is complicated further by the convention that economic statistics are produced separately for the onshore Scottish economy and its offshore counterpart (oil and gas production).

Nevertheless, the data that are available provide a useful overview of the pattern of Scottish trade, which can inform discussions about the economic consequences of independence.

As Scotland is a small country, its economy is reliant on international trade. In 2017, exports accounted for 58% of Scottish GDP and imports for 60%. By contrast, in the rest of the UK, exports and imports each account for around one-third of GDP. Scotland's most important exports are oil and gas, business services, and food and beverages (Huang et al, 2021).

The rest of the UK is by far Scotland's biggest trade partner, accounting for 61% of Scottish exports and 67% of Scottish imports in 2017. These shares have remained stable over the past 20 years (see Figure 1). Scotland's trade with the rest of the UK is around four times larger than its trade with the EU.

Figure 1: Share of the rest of the UK in Scottish trade



Source: Huang et al, 2021

Since Scotland makes up less than one-tenth of the UK's economy, trade within the UK is relatively more important to Scotland than to the rest of the UK. Scotland accounts for only 10% of the rest of the UK's exports and 9% of its imports (Huang et al, 2021).

Further, current levels of trade within the UK are higher than would be expected if Scotland and the rest of the UK were separate countries.

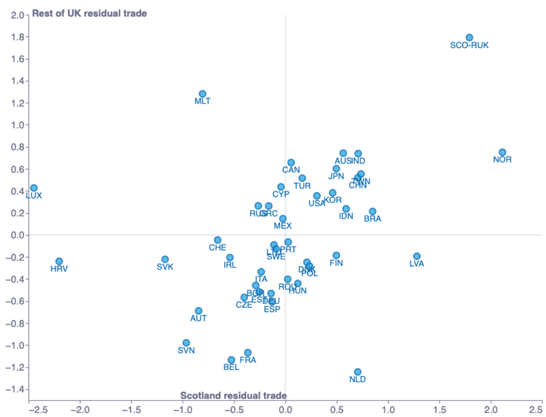
On average, trade flows between country-pairs are well explained by what economists call the gravity equation, which posits that trade is increasing in economic size and decreasing in trade costs (Head and Mayer, 2014).

Consequently, the difference between observed trade and the level of trade predicted by gravity gives a measure of unexplained or 'residual' trade, which we can use to identify country-pairs with unusually high trade levels.

Figure 2 shows Scotland and the rest of the UK's residual trade with a sample of their trading partners. The point labelled SCO-RUK in the upper right-hand corner shows residual trade between Scotland and the rest of the UK. For Scotland, the unexplained trade with the rest of the UK is higher than with any country except Norway. For the rest of the UK, unexplained trade with Scotland is higher than with any other country.

The size of the residual implies there is around six times more trade between Scotland and the rest of the UK than is predicted by the gravity equation. It is reasonable to conclude that at least part of this excess trade results from the fact that there is currently no international border within the UK (Huang et al, 2021).

Figure 2: Scotland and the rest of the UK's residual trade unexplained by gravity equation



Source: Huang et al, 2021

How might Scottish independence affect border costs?

If Scotland were to become independent, there would be a new international border cutting across the UK. This would increase trade costs between Scotland and the rest of the UK.

Available evidence suggests that border costs would increase even if, following independence, Scotland and the rest of the UK maintain a common economic market comparable in scope to the EU's single market (Santamaria et al, 2020).

It is highly uncertain how large the increase in border costs between Scotland and the rest of the UK would be. Economic studies of independence have assumed that border costs could increase by 15-30% if Scotland remains in a common market with the rest of the UK (Comerford and Rodriguez Mora, 2019; Huang et al, 2021). This is similar to the expected effects of Brexit on trade costs between the UK and the EU (Scottish Government, 2018; Bevington et al, 2019).

But the exact size of the cost increases is unknowable and would depend on what policies the Westminster and Holyrood governments were to adopt following an independence vote. In any event, it is likely that border costs within a common market between Scotland and the rest of the UK would only emerge slowly over a generation or more due to the gradual erosion of existing cultural, social and business ties.

How would border costs affect Scotland's economy? Higher trade costs increase import prices and reduce export opportunities, leading to falls in economic output. Consequently, border costs would have a negative effect on the Scottish economy (all else remaining equal).

Putting a number on the size of these losses is an imprecise art, but researchers have estimated that the combination of Brexit and Scottish independence could reduce Scottish income per capita by between 6% and 9% (Huang et al, 2021). These numbers are two to three times worse for the Scottish economy than Brexit because Scotland is more reliant on trade with the rest of the UK than with the EU.

It is important to remember that these estimates only consider the trade effects of independence. They do not take account of potential consequences of independence, such as changes in investment flows, immigration policy, fiscal transfers between Westminster and Holyrood, Scotland's currency or divergence in other areas of economic policy.

Ireland's experience shows that countries can successfully change their economic model following independence, but also that adjustment is a slow process.

Should an independent Scotland rejoin the EU?

After becoming independent, Scotland would face a choice over whether to rejoin the EU or to remain outside the EU in a common market with the rest of the UK. Could becoming a member of the EU offset the losses resulting from the introduction of a border with the rest of the UK?

Rejoining the EU would remove the customs and regulatory border between Scotland and the EU created by Brexit, and it would boost Scotland's trade with Europe. But this benefit would require a 'harder' border with the rest of the UK.

If Scotland were to rejoin the EU, its border with the rest of the UK would become one of the EU's external borders. As the UK is no longer part of the EU's single market or customs union, this means that cross-border trade would be subject to customs checks and other border barriers. In addition, physical border infrastructure would probably be required at crossing points between Scotland and England. Scotland would also have to abide by EU regulations and economic policies, further raising border costs due to the likelihood of regulatory divergence between the EU and the rest of the UK (Hayward and McEwan 2022).

Since the increase in border costs between Scotland and the rest of the UK would be greater if Scotland rejoins the EU than if it remains in a common market with the rest of the UK, an independent Scotland would face a trade-off. Should it put trade integration with the EU ahead of integration with the rest of the UK?

A good rule of thumb is that borders are less costly when they affect less trade. This suggests that as long as the rest of the UK remains Scotland's most important trade partner, Scotland would be better off prioritising integration with the rest of the UK, which means staying outside the EU.

Research that accounts for expected changes in trade patterns following independence concludes that rejoining the EU would not offset Scotland's economic losses from increased border costs with the rest of the UK. Estimated declines in Scottish income per capita, due to changes in trade following independence, are similar regardless of whether or not Scotland rejoins the EU (Huang et al, 2021).

Another recent publication also shows that Scottish independence is likely to reduce output and trade with the rest of the UK through increased border costs (Figus et al, 2022). But, in contrast to the study mentioned above, this analysis considers a scenario where rejoining the EU does not increase border costs with the rest of the UK more than staying outside the EU does. Consequently, it finds that rejoining the EU may partially reverse the economic effects of increased trade costs with the rest of the UK.

At least from a trade perspective, EU membership would not be a panacea for the economic challenges that independence would create by increasing border costs with the rest of the UK, Scotland's largest market

Lessons from Czechoslovakia.

/ Jan Fidrmuc / Jarko Fidrmuc /

In the early 1990s, a number of multinational unions disintegrated in Europe. First the Soviet Union collapsed in 1991, then Yugoslavia gradually broke apart during 1991-92 and finally Czechoslovakia split up at the end of 1992.

The last case was unique as the successor countries managed to steer clear of open nationalist conflicts and avoided major economic disruptions after the break-up. Instead, the dissolution of Czechoslovakia unfolded in an orderly and negotiated fashion – subsequently termed the Velvet Divorce (after the country's Velvet Revolution of 1989, which ended communist rule).

In comparison with the bouts of hyperinflation and bloody conflicts in the aftermaths of the Soviet and Yugoslav disintegrations, the Czechoslovak case stood out for being largely uneventful.

What were the economic effects of the break-up of Czechoslovakia?

Czechoslovakia's dissolution was also unique in that the two successor states – the Czech Republic and Slovakia – put considerable effort into maintaining solid economic and political ties with each other after separation. A customs union and free labour mobility continued until both countries joined the European Union (EU) in May 2004, when their bilateral agreement was superseded by the EU's single market.

The two countries also intended to continue using the koruna (crown), their common currency. But in contrast to the customs union and common labour market, the currency union proved short-lived, collapsing after only six weeks. The Czech Republic continues to use its own koruna, which it introduced in 1993. Slovakia, on the other hand, decided to give up its newly acquired monetary autonomy in favour of joining the euro area in January 2009 as the second country in Eastern Europe (after Slovenia in 2007).

Despite different starting conditions and diverging policies, economic developments in the two countries have followed surprisingly similar trajectories. Unemployment in Slovakia rose sharply immediately after independence, but it declined as the country benefited from significant inflows of foreign direct investment after joining the EU (see Figure 1).

Figure 1: Unemployment rates in the Czech Republic, Slovakia and the EU

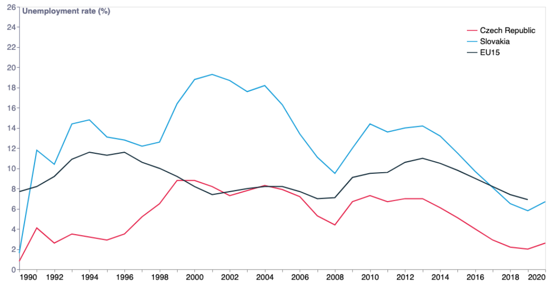


Figure 2: Inflation rates in the Czech Republic, Slovakia and the EU

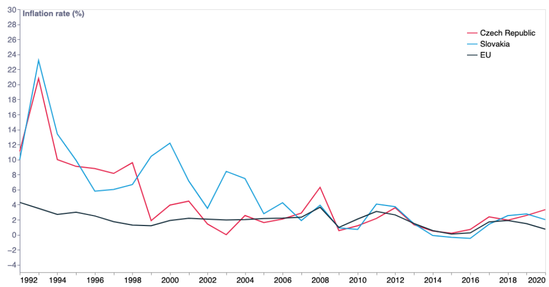
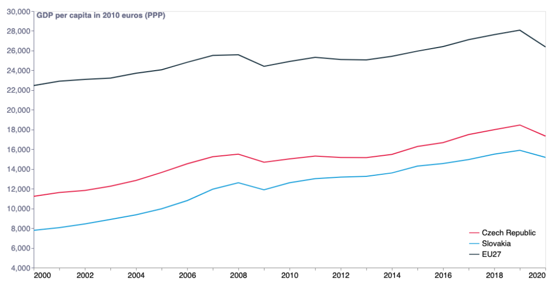


Figure 3:GDP per capita in the Czech Republic, Slovakia and the EU



Source: Eurostat, Oesterreichische Nationalbank, European Commission
Note: EU15 – 15 member states (as before 2004), EU27 – not including the UK

The difference in unemployment between the two countries fell from 10 percentage points at the beginning of the 2000s to only two percentage points in 2008. It increased slightly after the global financial crisis of 2007-09, but the evolution of unemployment has remained remarkably similar in both countries. This reflects not only that the two labour markets have remained largely integrated despite the break-up, but also that they have followed similar industrial developments, especially a focus on the automotive industry. This creates important spillovers between the two countries and regions within them.

Despite their different monetary policies, the similarity of inflation developments in the two countries is also stark (see Figure 2). The initial devaluation of the Slovak currency – together with politically motivated and excessive public spending – fuelled an acceleration of inflation in Slovakia during the 1990s and at the beginning of the 2000s.

Nevertheless, the objective of becoming a member of the euro area motivated the authorities to bring inflation down to 2% a year by the end of that decade. Despite having an independent currency, Czech monetary policy and its outcomes have closely followed developments in the euro area.

What can we learn from the experiences of the Czech Republic and Slovakia?

Given the orderly nature of the establishment of the Czech Republic and Slovakia – and the continuation of close economic ties afterwards – the dissolution of Czechoslovakia could offer important lessons for other countries hoping to follow a similarly amicable path as they part ways. Although the starting conditions are largely different, there may still be valuable lessons for Scotland and the rest of the UK to consider if Scotland were to become independent.

Currency

First, the cost of betting on currency separation can be very low while the potential profits are large. In the Czechoslovak case, it was widely expected that any new Slovak currency would depreciate against the Czech currency once both were introduced. In anticipation of this, Slovakia experienced capital flight in late 1992 and early 1993 (even though official policy was to retain the koruna): Slovak households and firms sought to hedge against the possibility of the introduction, and devaluation, of Slovak currency by converting funds into hard currency or transferring them to Czech banks.

This capital flight was the main reason why the two successor states decided to abandon the common currency after only six weeks. The Slovaks who transferred their funds to Czech or foreign banks were then rewarded with a handsome profit of around 20%. Discussions of Scotland's currency options are undertaken elsewhere in this series .

One clear lesson is that if two currencies are expected to diverge in the future, the anticipation of this change can create an immediate incentive to transfer funds to whichever country is expected to end up with the stronger currency. The cost of such speculation is essentially zero: it is as easy as transferring one's account balance. As long as the common currency survives, the holder of funds deposited in either country can continue to use them in either country. But once the separation happens, the profit (or loss) will be equal to the rate of devaluation (or appreciation).

Promises and reality

Second, the case of Czechoslovakia demonstrates that there is often a disconnect between politicians' public pronouncements before an important decision (such as independence) and the subsequent reality. The voters, especially those in Slovakia, were promised that independence would bring instant benefits. Instead, as Figure 1 shows, independence was followed by a discrete increase in unemployment.

Similarly, voters may not, in reality, keep the politicians accountable for their pre-independence promises. As a result, political developments may gain their own dynamics as the disintegration of the union unfolds, which could be difficult to foresee in advance.

Trade

Third, while bilateral trade is bound to fall after disintegration, some of this is likely to be due to trade diversion, not trade destruction. In the case of the Czech Republic and Slovakia, goods and services that used to be traded within Czechoslovakia found new buyers elsewhere, primarily in the EU.

If Scotland were to become independent, it would likely seek access to new markets. Given Scotland's location, obtaining some kind of preferential trade arrangement with the EU would seem the obvious choice.

In that way, some of the expected loss of trade with the rest of the UK could be compensated by a growth of trade with the EU (as has been the case in Ireland over many decades). Of course, this will not be instantaneous. Nevertheless, the Czechoslovak experience shows that it is possible for a small country to build new partnerships with larger trading blocs like the EU relatively quickly.

Despite the short-term costs and disruptions, the Czech Republic and Slovakia have prospered since gaining independence. Both joined the EU in 2004 and are also members of the OECD. In terms of GDP per capita, both countries are making progress at closing the gap with the EU average (see Figure 3). They have gone from approximately half (Czech Republic) and one-third (Slovakia) of the EU level to 66% and 58%, respectively, during the last two decades.

One could even argue that the separation in 1993 has brought some favourable outcomes: for example, the two successor countries have become less politically unstable. The two countries (and their citizens) maintain close ties: they are both part of the Visegrád Group (along with Hungary and Poland); and Czechs and Slovaks frequently cross the border, as tourists and migrants alike.

Similarly, Scotland and the rest of the UK could prosper and maintain vibrant economic ties with each other

Goodbye steel.

Since the 1960s, Scotland's constitutional politics have been moulded by competing assessments of the nation's contemporary and future economy. The decline of industrial jobs and the economic changes that have followed underpin current independence debates.

/ Ewan Gibbs /

Competing economic perspectives – primarily on whether Scotland would be better or worse off without the rest of the UK – have formed the backdrop to debates on Scotland's constitutional future.

Since the electoral breakthrough of the Scottish National Party (SNP) during the 1960s, the dichotomy between 'rich Scots or poor Britons' has been a dominant theme in the argument for independence (Cameron, 2012). On the other hand, opponents of Scottish independence have emphasised the economic benefits of the Union through access to a large national market, currency stability and net benefits arising from public spending (known as fiscal transfers).

Economic historians are increasingly emphasising the centrality of deindustrialisation – the decline in the significance of industrial activities in Scotland's economy and especially in employment – as a dominant driver of dissatisfaction with the Union since the mid-20th century. It was at this time that Scotland's staple industries of coal, steel, shipbuilding, heavy engineering and textiles began shedding tens of thousands of jobs (Phillips, 2017).

It was against this backdrop that long-term assessments of the benefits and costs of the Union were developed – such as Clive Lee's 1995 'balance sheet' study of Scotland in the 20th century, which emphasised that the declining Union dividend was important in shaping growing support for independence. This can be understood in a global context where deindustrialisation has often been seen as a key explanation of political turbulence.

The international Deindustrialization and Politics of Our Time research project points to Brexit, the 2016 election of Donald Trump as US president and the rise of right-wing 'populism' across European countries as being the result of factory, coal mine, shipyard and steel mill closures.

In Scotland, deindustrialisation accentuated national consciousness through motivating a civil society campaign for a devolved parliament within the UK and contributed to rising support for independence. These outcomes, which have reinforced the dominance of a centre to centre-left alignment in Scottish politics, suggest that the politicisation of economic changes associated with deindustrialisation has not necessarily led to a shift to the right or to hostility towards European integration.

How did the structure of Scotland's economy change?

Scotland was a mature industrial society in the middle of the 20th century, but one strongly marked by evidence of deindustrialisation by the end of the century (see Table 1). The last deep coal mine in Scotland closed in 2002, while the industry had employed over 80,000 miners in the late 1950s. Basic steel production and jute manufacturing also came to an end during the 1990s following decades of jobs losses.

This period is associated with the SNP's electoral breakthrough. The party's initial rise to prominence began with the 1962 by-election in West Lothian, a county suffering from the impact of coal and shale mine closures.

Table 1: Scottish industrial employment since 1901

Year	Total workforce	Mining and quarrying	(%)	Manufacturing	(%)
1901	1,982,812	132,183	7	923,800	47
1951	2,357,000	100,000	4	818,000	35
2001	2,261,281	28,118	1	299,213	13
2021	2,500,000	33,980	1	202,396	8

Figure 1: Scottish manufacturing employment

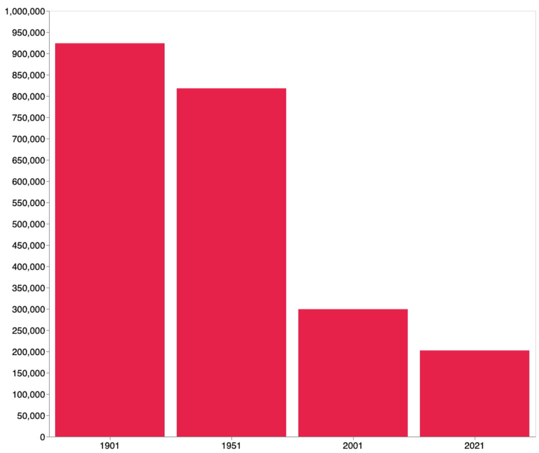


Figure 2: Scottish industrial employment

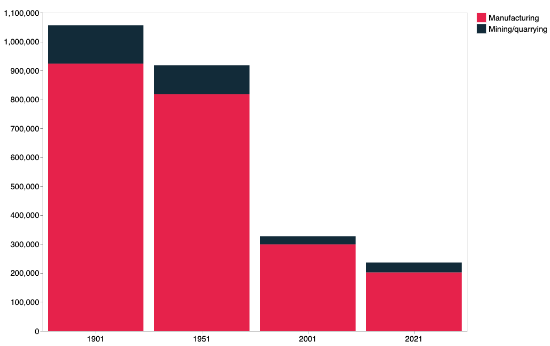
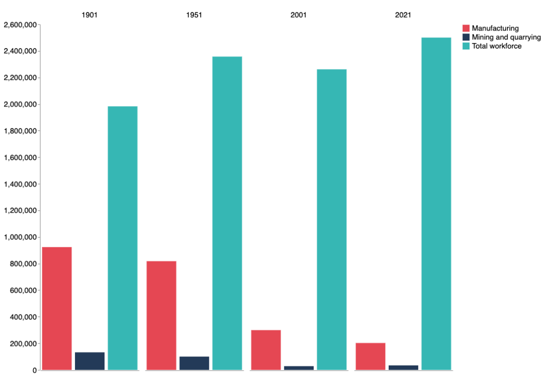


Figure 3: Scottish employment by selected sector



Source: Population Census 1901; Digest of Scottish Statistics 1953; Population Census 2001; Scottish Government, Scotland's Labour Market: People, Places and Regions – background tables and charts (2021)

Billy Wolfe, a future SNP leader, and the party's candidate at the 1962 West Lothian by-election, accused the UK government, the European Free Trade Area and multinational oil corporations of economic and social 'murder' for ending shale oil subsidies. In 1967, the SNP won a parliamentary constituency for the first time since the Second World War at the by-election in Hamilton – an area formerly at the heart of the Lanarkshire coalfields, which had been strongly affected by pit closures over the preceding two decades.

Historians and social scientists see these changing alignments as being down to shifts in Scotland's economy. Christopher Harvie, who went on to become an SNP member of the Scottish Parliament in the 2000s, highlights the demise of Scotland's 'old fashioned tycoons', who had formerly dominated industrial communities built around coal mining, steelmaking, shipbuilding and locomotive engineering. Their replacement by a combination of nationalised industries owned by the UK government and the growing presence of multinationals, including US companies, encouraged the development of nationalist arguments.

Insofar as these changes to Scotland's economy were actively encouraged by the UK government, Wolfe's criticisms were not just convenient rhetoric (Tomlinson and Gibbs, 2016). But as researchers point out, important decisions were made in Scotland during this time, especially by Scottish Office officials pursuing an agenda of urban and economic reconstruction that was surprisingly durable through changes in government over the post-war decades (Collins and Levitt, 2016).

Defenders of UK regional policy, which was most marked under Harold Wilson and Jim Callaghan's Labour governments of the 1960s and 1970s, contend that their policies were – at least for a period – successful.

For example, the building of a car factory at Linwood in Paisley, to the west of Glasgow, secured almost two decades of manufacturing employment for former shipbuilders and miners who were provided with cleaner, safer and better-paid jobs until its closure in 1981. Linwood could be seen as an example of the case for the Union in action: the UK government used both investment restrictions in 'overheating' regions and incentives such as tax breaks and grants to ensure that first Rootes, a UK car company, and then a US multinational provided work in Renfrewshire following the factory's takeover by Chrysler in 1967. The plant finally closed in 1981 following a brief period of ownership by Peugeot-Talbot (Phillips et al, 2019)

What were the political effects of deindustrialisation?

The closure of Linwood was a formative event. Its cultural impact was demonstrated when the Proclaimers' sang 'Linwood no more' on their 1987 hit single, Letter from America, which emotively contrasted Scotland's late 20th century industrial closures with the Highland Clearances (the eviction of inhabitants of the Highlands and Islands primarily between 1750 and 1860).

Current SNP MP, Pete Wishart, was among the musicians from Runrig who headlined the 'A Day for Scotland' event convened by the Scottish Trades Union Congress (STUC) during the summer of 1990. This was a politically charged occasion that sought to affirm the role of a lively autonomous national culture in supporting industrial campaigns, especially opposition to the closure of Ravenscraig steel mill in Motherwell, North Lanarkshire.

These were not incidental cultural moments for Scottish nationalists. SNP supporters had made steel a core issue in their campaigning since the 1970s, especially in Lanarkshire. Those decisions followed the nationalisation of the steel industry in 1967 and a series of rationalisations and plant closures (Lawson, 2020). Steel was held up as an archetypal example of the failure of the Union to realise the potential that Scotland's industrial base offered. Instead, Scottish mills were held to be disadvantaged by decision-making in London that favoured larger English conurbations.

The Labour Party was pressured by nationalist outlooks grounded in territorial politics that followed a zero-sum logic, with Scottish workers held to have been let down by decisions that served the interests of Labour constituencies in other parts of the UK. These arguments were given greater potency in the context of North Sea oil. Nationalists claimed that Scotland was losing out from a major windfall, especially during the period of high oil prices between 1973 and 1986, as UK government decision-making prioritised the pace of extraction over achieving longer-term fiscal and industrial benefits.

Comparisons with Norway, another small northern European nation of around five million – which achieved a far more favourable outcome in terms of public spending and manufacturing developments from North Sea oil – have become a commonplace argument for Scottish nationalists (Holden, 2013). These were repeated in the 2018 Growth Commission, a vision for independence that broadly put forward a post-oil perspective for Scotland's economy and fiscal regime. The Commission underlined the success of Norway's sovereign wealth fund and the potential for Scotland to match this through its own natural resource revenues.

What are the long-term effects of deindustrialisation?

The politics of coal and car manufacturing seem distant from discussions of Scottish independence in the 21st century. Much of this shift took place through Alex Salmond's modernisation of the SNP during the 1990s and 2000s, under which the party embraced the realities of globalisation and European integration (Jackson, 2012). Old arguments for economic sovereignty were jettisoned in favour of financial liberalisation modelled on Ireland's 'Celtic tiger'.

Salmond summarised this in 2008, the year after he became first minister, when he argued that Scots 'didn't mind' the economic changes wrought by Thatcherism. It was the 'social' implications of how the unemployed were treated and divisive industrial conflicts to which they objected. Explaining his conversion to support Scottish independence shortly before the 2014 referendum, Scotland's foremost historian Tom Devine similarly hailed the end of 'dinosaur heavy industries', while regretting the excesses of the 'radical surgery' that Conservative governments pursued during the 1980s and 1990s.

Economic debates over Scottish independence have often focused on the fiscal consequences of such a decision and the validity or otherwise of projections from the annual Government Expenditure and Revenue Scotland (GERS) figures. Questions around currency choice and access to UK and European markets also loom large. Yet both the experience of deindustrialisation in the past and the potential for managing future changes to Scotland's economic structure – for example, through the transition to net-zero carbon emissions – play important roles in contemporary independence debates.

During the 2021 Scottish Parliament election campaign, the first minister, Nicola Sturgeon, explained that memories of growing up around the 'devastation' of coal and steel closures in Ayrshire made her 'determined' that oil communities in the North East of Scotland would not face the same experience. By contrast, the lead opposition party, the Conservatives, has presented the nationalists and their Green Party allies as a threat to oil workers, arguing that only the UK's 'broad shoulders' can ensure a viable transition to renewable energy sources.

What lessons can we learn for today?

In the contemporary international context, one important lesson to draw from Scotland's experience of deindustrialisation is the comparatively malleable ways in which economic changes are understood, as well as the complex nature of the relationship between demands for political and economic sovereignty. The latter was far more forcibly articulated in Scotland during the 1970s and 1980s than it is at present when independence is higher up the political agenda than it was throughout the previous century.

These research findings are important when globally deindustrialisation is often associated with right-wing populism (Gamez, 2021). They also support similar conclusions drawn from Wales about how the legacy of coal mining has reinforced a centre-left national consensus (Beynon et al, 2012).

Another important conclusion that can be drawn from the Scottish experience is the role of path dependencies – or how historical experiences shape contemporary discussions. For example, the SNP's understanding of renewables, and their place in public discussion, has been strongly shaped by oil (Gibbs, 2021). These cases point to the role of contingency and the need to be attentive to long-term developments to understand how economic affairs are interpreted politically

WHAT NEXT FOR THE UNION?

Recent UK governments have 'devolved' power to Scotland, Wales and Northern Ireland. This is a simple idea, but the UK brand of devolution is complex. Its stability has been threatened by both the Covid-19 pandemic and Brexit.

/ David Bell /

Threats to the UK's political unity have been met by 'devolving' power to the smaller nations – Scotland, Wales and Northern Ireland – by successive governments in Westminster. The economic components of these changes mainly focus on extending tax-raising powers.

This process of expanding fiscal powers was in train when the economy was hit by the Covid-19 pandemic. Further change came with adjustments to the UK regulatory framework – such as the Internal Market Act and the Subsidy Control Bill – following Brexit. These external shocks have cast doubt on the stability of the fiscal frameworks that control tax and spending by the devolved administrations in Edinburgh, Cardiff and Belfast.

What is the constitutional framework of the UK?

The UK is unusual in not having a written constitution that codifies the powers and constraints on different levels of government, including which levels of government control tax and spending powers. A codified constitution enables disputes between state/province and federal/national governments to be resolved in court.

In contrast, the UK parliament in Westminster is 'sovereign': laws that are challenged in the courts can be rewritten. Rather than providing explicit legal protection, the UK has relied on the integrity of politicians to deal equitably with different groups and interests within UK society.

This is known as the 'good chap' theory of governance. It has been called into question – with some arguing that recent events, for example around the Brexit referendum, mean that good behaviour among politicians can no longer be taken for granted (Blick and Hennessy, 2019). Nevertheless, it continues to shape political and economic relationships between the UK government and the other nations.

The UK is a union made up of the four nations – England, Scotland, Wales and Northern Ireland. The tax powers of the individual nations are limited. England comprises 84% of the UK population and UK economic policy is inevitably heavily influenced by economic conditions in England.

What is the history of devolution in the UK?

Opposition to the UK's political arrangements in the smaller nations, though never absent, has become increasingly strident in recent decades. This opposition precipitated referendums on devolution in Scotland and Wales, and an independence referendum in Scotland in 2014. Though armed conflict in Northern Ireland was halted by the Good Friday Agreement in 1998, substantial support for reunification with the Republic continues.

In an effort to provide greater autonomy for the devolved nations, the UK government sought to amend the status quo by passing a series of acts, beginning with the Scotland Act 1998, that first brought new legislatures into place in Scotland, Wales and Northern Ireland, and subsequently increased the political and economic powers of these bodies. This process has come to be known as devolution.

Enhanced economic powers have been a central pillar of devolution. These largely address fiscal issues – taxation and government spending. The economic justification for increasing the fiscal powers of lower levels of government goes back to the 1950s and 1960s (Tiebout, 1956; Oates, 1969). A key argument is that lower levels of government are better placed to respond to the preferences of their electorates and that actual or threatened mobility deters local politicians from imposing punitive taxes to fund unpopular spending.

Alongside its highly centralised political governance, the UK also had a more centralised tax and public spending system than most other advanced economies (McCann, 2021). The OECD estimated that in 2014, subnational government revenues in the UK comprised 1.6% of GDP and 5.9% of total public tax revenue. This compares with OECD averages of 7% of GDP and 31.6% of public tax revenue (OECD, 2016).

The 'Barnett formula', which has been in existence since 1979, largely determines funding for the Scottish, Welsh and Northern Irish administrations. They receive an allocation of their population shares of any increases in spending agreed by HM Treasury for England.

At each budget, the Treasury calculates the 'block grant' for the devolved nations by applying this formula. This has been advantageous for Scotland and Northern Ireland because since its introduction, the Barnett formula has provided higher levels of public spending per person than in England. Its continued application maintained their spending advantage because each time spending per person in England rises, their budget increases by the same amount.

What is absent from the Barnett formula is any recognition that the needs of different parts of the country are not equal. By applying the same increase in spending across component parts of the UK, it is not responding to differences in unemployment rates, levels of poverty, poor public health and so on.

Most advanced countries set their subnational financial arrangements to support areas that experience disadvantage. This issue was particularly relevant for Wales, which suffered significant economic decline that application of the Barnett formula failed to mitigate. This issue has been allayed by ad hoc adjustments to the formula.

What is also absent from the formula is any legislative underpinning. It is calculated and administered by the Treasury, which is free to change how it is determined. This provided useful flexibility during the pandemic, as we shall see, but is frustrating for the devolved administrations, which have no right to appeal Treasury decisions.

Have there been recent changes to devolution in the UK?

Significant changes to the fiscal architecture in Wales and Scotland were underway when Brexit and then the pandemic occurred. These shocks severely strained relationships between the UK government and the devolved administrations.

Brexit brought them under strain because of conflict between Westminster and the devolved administrations over powers returned from the European Union (EU). These included competition policy, state aid and trade. Brexit also ended EU structural fund support for deprived areas, which was particularly important for Wales. The approach taken by the UK government to deal with these returning powers has not been popular in Wales and Scotland.

In Northern Ireland, the changes do not apply, because, under the Protocol to the Trade and Cooperation Agreement (TCA), Northern Ireland remains part of the EU single market for at least the next four years. This has raised issues associated with the movement of goods between Great Britain and Northern Ireland, since they are also crossing a boundary of the EU single market. Fractious negotiations between the UK and the EU over this issue have yet to be resolved.

For Scotland and Wales, the Internal Market Act replaced EU competition policy. It sets 'mutual recognition' rules for trade within the UK, meaning that if a good is accepted for sale in one nation, it must be accepted in all the others. This will deter them from legislating to establish different product standards in areas where it is felt that the devolved parliaments have a legitimate interest – such as building standards.

The Subsidy Control Bill, required by the EU to prevent the UK from competing unfairly with its companies, makes the UK Secretary of State for Business, Energy and Industrial Strategy (BEIS) and the Competition and Markets Authority the ultimate arbiters of what financial support to companies is allowable. Again, Scotland and Wales feel that their powers to support economic development are being infringed. This is especially the case as the Scottish and Welsh governments have had no role in post-Brexit deals.

Most nations at least consult their province or state governments when negotiating trade deals, especially where their specific interests are at stake. Agriculture has more economic importance in both Wales and Scotland than in England, yet the UK government did not consult the respective governments during trade negotiations with Australia and New Zealand, both major agricultural exporters.

Finally, although included in the 2017 Conservative Party manifesto, the UK government took until January 2022 to announce the introduction of the 'Shared Prosperity Fund' as the replacement for EU structural funds. The delay and lack of consultation was keenly felt in Wales where the 2014-2020 round of EU funding was worth £800 per person per year (Bell, 2017).

The pandemic posed another set of challenges to the fiscal frameworks of the devolved nations. But in this instance, the lack of legally binding fiscal arrangements between the UK government and the devolved nations was perhaps advantageous. The health and economic costs of the pandemic caused an increase in UK borrowing of around £300 billion within the course of a single financial year.

The devolved authorities shoulder the main responsibility for public health within their territories and were confronted with massive unbudgeted cost increases. Spending on health measures were increasing rapidly in England, which would normally trigger additional funding – 'consequentials' for the devolved nations via the Barnett formula. Yet the governments in Scotland, Wales and Northern Ireland were unsure whether these would materialise and over what time scale. Their powers to borrow are very limited and well below what was required in response to the pandemic.

HM Treasury responded quickly with offers of substantial financial guarantees to the devolved governments. These were based on the implied Barnett consequentials and gave them assurance about their funding to combat the pandemic. This was an ad hoc short-term response that might have been impossible if constrained by restrictive funding regulations or legislation.

Where might devolution go next short of full Scottish independence?

The fiscal powers available to the devolved administrations have increased dramatically during the last decade. A recent report reviewing possible powers for Northern Ireland provides a useful overview of the options.

Some argue that the powers should extend to 'full fiscal autonomy' – which would mean that the devolved administrations would keep all taxes raised within their borders, control all public spending affecting their citizens and make an annual payment to the UK government for central services, such as defence, foreign affairs and debt interest.

This would mean that there would be no sharing of risk between the nations. It would also mean that issues of fiscal sustainability would focus almost entirely on the devolved nations.

Indeed, the additional risks that have already been taken on by the Scottish government through the block grant adjustments have not improved its fiscal position. As a result, there may be some hesitation within the devolved governments around accepting additional fiscal powers. One approach would be to let Edinburgh, Cardiff and Belfast choose how far to extend their own fiscal powers on the clear understanding that they must live with the consequences (Bell et al, 2021).

Conclusion

The challenges of Brexit and the pandemic have strained the UK's version of devolution in different ways. They highlight the advantages and disadvantages of somewhat loose fiscal arrangements between different levels of government. But these fiscal arrangements were already scheduled to change before the unexpected challenges posed by Brexit and the pandemic.

Together, they have stretched the policy bandwidth of all of the governments and perhaps contributed to a worsening of intergovernmental relations. Whether the UK as a union of four nations will be less resilient as a result of all of these changes remains to be seen.

For economists, part of the lesson from these events is the need to consider that the process of economic policy-making, whether as a result of agreed plans or in response to external shocks, is not costless and that the policy production function, like any production process, has finite limits.

UK policy-makers may respond to any increased demand for Scottish independence with the promise of 'more powers', but any further reform should consider the overall fiscal system – both in Scotland and the UK – as opposed to relying on further piecemeal reforms targeted at individual taxes or spending responsibilities

Power and responsibility.

The economic aspects of Scottish independence are of great importance, but only when viewed as part of a process that will change institutions, governance, power relations and behaviour – and where economic concerns stand alongside concerns with social and moral priorities.

/ Andrew Cumbers / Sheila Dow / Robert McMaster /

The economic arguments leading up to the 2014 referendum on Scottish independence generated considerable heat and some light on the central question of whether Scotland could prosper on assuming the powers associated with political independence. Both sides of the debate emphasised the importance of economic issues in their arguments.

The 'Yes' campaign argued that the Scottish economy was strong enough to support a sound fiscal position under independence, with monetary stability emphasised through the continuation of a currency union with rest of the UK.

'Better Together', which supported Scotland remaining part of the UK, argued that uncertainty caused by independence would be economically and fiscally damaging (removing the fiscal risk-pooling of the Union), while anything other than a currency union (which the then UK government had ruled out) would be economically damaging.

For Better Together, independence was a risky and insecure option compared with the perceived stability of the status quo. Their view was that it would produce a negative 'shock' to the economy and the uncertainty associated with independence would, almost by definition, be damaging.

In contrast, pro-independence supporters evoked the positive benefits of autonomy for Scotland. They argued that dynamic effects over the longer term would provide the capacity to promote economic growth and social goals through different priorities for taxation and spending.

These arguments on both sides were expressed primarily in terms of a particular approach to economics that does not take account of the institutional changes that are always at the centre of constitutional change.

Indeed, in our view, the referendums on Scottish independence in 2014 and on the UK leaving the European Union (EU) in 2016 presented problems for the relevance of mainstream economics, which centres its perspective on an equilibrium generated by market forces rather than the dynamism and evolution that characterise economic processes.

This focus means that uncertainty is only associated with disturbance from equilibrium rather than being an ingrained feature of economic life. Further, their models – the theoretical constructs used to understand economic behaviour – tacitly assume the continuation of a particular institutional arrangement. They typically assume that equations reflect previous relationships between variables, which are replicated over time (Gudgin et al, 2018). In effect, they assume that institutional relationships are fixed. Of course, the whole point of any possible constitutional change is that institutional relationships also change.

Further, the mainstream focus on formal models is such that the results are deemed to be acceptable as a complete argument. They can be useful for guiding thought about economic issues when combined with other forms of argument. But formal models inevitably brush aside many important issues that cannot be expressed formally or fully quantified. This applies particularly to discussions of institutional change and evolving power relations. Institutional changes affect the balance of power, and thus economic outcomes, in multiple spheres where mainstream models preserve the status quo.

This applies to internal and external relationships. Internal here includes, for example, relations between large and small businesses, financial and non-financial interests, employers and employees, and Scottish households and organisations. External relations include those between the Scottish government and the rest of the UK and the European Union (EU), as well as Scottish-based businesses and their organisational and trading relations with foreign firms and markets.

Thus, many of the standard economic frameworks used narrow the scope of debate. In the 2014 referendum, economic arguments typically centred on the fiscal position of an independent Scotland, transfers between the rest of the UK and Scotland, and possible changes in currency arrangements. This, in our view, neglected the effect of independence on important factors, such as power relations and the structure of the economy.

Our premise here is that these arguments – on both sides – were informed by an exclusive fixation on economic modelling and the insistence on precise quantification of the costs and benefits of constitutional change, devoid of placing change itself in a broader political context. (For more discussion of these issues, see Dow et al, 2018.)

The pivotal debate on the question of currency is illustrative of these limitations. For the leadership of both sides – noting that there were dissenters in the independence camp who backed the idea of creating a new currency – the continuation of a sterling currency union was predicated on the assumption that sterling fulfilled the 'optimal currency area' criteria of economic theory.

Evidence suggests otherwise. An 'optimal currency' requires regional balance throughout an economy, or fiscal transfers that ensure balance. Yet the UK has one of the most regionally unbalanced economies in Europe (Cumbers, 2013; Martin et al, 2016; Christophers, 2020). This is manifested in the century-long problem of the 'North-South' divide and the more recent and growing inequalities in wealth between 'London and the rest'.

In particular, the UK may be subject to a 'finance curse', given the relative size of the sector in relation to the economy as a whole (Christensen et al, 2016; Christophers, 2020). This phenomenon distorts activity in other areas of the economy by raising exchange rates, for example, which may discourage manufacturing and other exports. It also partly contributes to a polarised labour market, typified by relatively low productivity growth in peripheral regions. Yet the serious problems of the structure of the UK economy barely featured in the independence debate in 2014.

How has Brexit changed the debate on Scottish independence?

Events since the 2014 referendum have demonstrated the limits of readings focused exclusively on economic arguments.

The 2016 EU referendum, for example, not only resulted in major constitutional changes to the UK's relationship with the EU but also to some seismic changes in its geo-economic relations with the rest of the world.

As with the referendum on Scottish independence, the economic arguments were once again largely predicated on mainstream economic modelling exercises of either the positive or negative effects expected. Again, these failed to take account of what we would term the broader political economy of Brexit – the political, social, cultural and institutional dynamics surrounding the UK's departure from the EU, and its subsequent relations both internally and with the rest of the world.

Internally, as we have noted, the UK's economic geography was hugely unequal prior to both the 2014 referendum and Brexit. The wealth gap between the UK's richer and poorer economic regions has widened since the 2016 referendum (Fetzer and Wang, 2020). This has been compounded by the failures of the UK government thus far to replace decades of EU support for agricultural areas and 'left behind' places.

This suggests, at best, that arguments for leaving the EU that were based on a minimalist state model in a deregulated 'global Britain' underestimated the importance of policy institutions and infrastructures to achieving balanced economic development and the promised 'levelling-up' agenda.

Meanwhile, the shock associated with exiting the EU's single market, and its implications for supply shortages and diminishing trade, seem to have been underappreciated by the Leave campaign. That said, while advocates of Leave underestimated a range of issues, the Remain campaign exaggerated the immediate impact of Brexit (though not necessarily the long-term impact). Their apocalyptic premonitions largely failed to materialise, demonstrating the importance of paying attention to the timeframe for transitional arrangements in economic change.

It has been the institutional and regulatory changes that have most inhibited the UK's economy post-Brexit, but in a more fragmented, uneven and non-linear fashion than mainstream modelling exercises foresaw.

What can a political economy understanding of constitutional change add?

In the two referendums, both sides presented their arguments as though the models they used were reliable and capable of yielding precise quantitative predictions that would be definitive. This is the style of argument of the independent and objective scientific expert providing input to political debate. But if, in fact, the models have serious limitations – not least in incorporating questions of institutional design, social values, uncertainty and the continuing and iterative dynamics of economic life – as opposed to a rather static sense of the status quo, then other types of argumentation are required.

Clearly the political and institutional landscape has changed dramatically since 2014. One inescapable fact about any future debate on the economic case for

Scottish independence is that the terrain – by which we mean the political, economic, social and cultural context – has shifted significantly.

Brexit is one major element of this, but so too are the effects of another half decade of UK government austerity policies designed to reduce the size of government and cut welfare spending. More recently, the implications of the pandemic have played a role, as have developments in the oil and gas sector.

Those for and against independence will need to fashion new arguments that take account of these changing circumstances in ways that reflect the grounded realities of political and institutional life. In particular, they will need to consider how these have empowered or disempowered different social groups, businesses, organisations, households, communities and geographical regions. Any modelling input needs to be designed in such a way as to be compatible with other arguments within this broader framing.

So far, the grounds for optimism here are slight. Those arguing against independence once again seem to be rehashing older arguments about stability and the benefits of 'pooling' resources in a larger union, now extended to include dealing with a public health crisis. Reference continues to be made to the benefits of staying within the UK's so-called 'single market' and the negative trade effects for Scotland of leaving a union with its largest partner.

But free UK access to the EU's single market has already been lost and inequalities within the UK have widened due to austerity policies and the effects of the pandemic (Scottish Government, 2021). Further, there is confusion and a great many unresolved issues regarding the UK's future political and economic relationship with the EU. Arguments for the Union based on stability and pooling of resources look somewhat threadbare at present.

Similarly, arguments by some in the pro-independence campaign – notably the recent Growth Commission Report – that place a high priority on monetary stability and fiscal caution, not least in maintaining the presumption of 'sterlingisation' as desirable 'for a possibly extended transition period' (emphasis added), seem to resonate with a more mainstream framing.

A broader political economy perspective would arguably place greater emphasis on different trajectories to be pursued that would involve alternative policy choices to the status quo. The economic prospectus for Scottish independence is ultimately one of transition from one set of constitutional arrangements to another with the consequent implications for changing governance relations, institutions and practices.

There are very different pathways that can be taken by sovereign governments. The policy mechanisms and institutional arrangements open to them can have decidedly different effects (see, for example, John Kay's remarks on a Jersey-type arrangement). This is evident, for example, from a compelling new monograph comparing Chinese gradualism with Russia's shock therapy treatment in the transition from fully planned to market economies (Weber, 2021).

In this regard, a new Scottish currency, central bank and full autonomy over monetary and fiscal policies would enable new choices compared with a UK government increasingly in hock to financial interests. Inevitably there would be risks and uncertainties, not least in the relations between a newly independent Scottish economy and the rest of the UK, including:

- What would the trading relations be?
- How would financial assets, particularly pensions, be treated?
- How easy would it be for Scotland to rejoin the EU, and on what terms?

Politically, it seems that there is considerable support for an independent Scotland rejoining the EU. But inevitably there would be costs involved in processes of transition, as well as benefits. The likely effects of uncertainty on the transitional path would need to be taken into account when designing the institutional arrangements for transition.

What Brexit has demonstrated above all is the importance of uncertainty and risk in economic and political life as integral features rather than something external to steady state assumptions around equilibrium-based models in mainstream economic theorising.

The economic aspects of independence are indeed of great importance, but only when viewed as part of a process that will change institutions, governance, power relations and behaviour (with economic consequences). These economic concerns should be considered alongside concerns with social and moral priorities. Most economists did the 2014 debate a disservice to the extent that their approach distracted attention from these other aspects of independence.

The economy matters, but so does the way it is understood and analysed. For us, a political economy approach that frames economic considerations within critical constitutional and institutional issues and is alert to the dynamic alternative trajectories is a more preferable terrain for a renewed independence debate ●

ECONOMICS AND THE REFERENDUM.

Voters' perceptions of the economic outcomes of independence played an important role in the result of Scotland's referendum in 2014. Following Brexit, the debate is no longer just about Scotland's relationship with the rest of the UK, but also the European Union.

/ John Curtice /

Scottish voters' evaluations of the economic consequences of independence played a central role in the choice that they made in the 2014 referendum (Curtice, 2021).

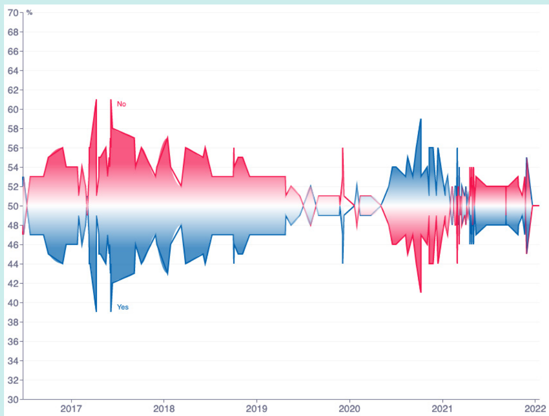
In their final poll conducted before the vote, YouGov found that no less than 98% of those who said the country would be worse off if Scotland became independent were backing 'No' in response to the question that the referendum asked: 'should Scotland be an independent country?'. On the other hand, 97% of those who felt the country would be better off intended to vote 'Yes'.

Similarly, Opinium reported that 99% of those who thought that independence would benefit the economy were backing leaving the rest of the UK, while 98% of those who felt the economy would be damaged were intending to vote to remain within the Union.

The fact that those who thought Scotland would be worse off (47%) outnumbered those who believed it would be better off (35%), and that more people felt that the economy would be damaged (45%) than believed it would benefit (37%) undoubtedly put the 'No' side at a decided – and perhaps even decisive – advantage. This was borne out when the Scottish electorate voted 55% to 45% in favour of remaining in the Union.

In contrast to the outcome of the referendum seven and a half years ago, Scotland now – according to the polls at least – is evenly divided in its attitude towards independence (see Figure 1). On average, the last half dozen polls (undertaken between late October 2021 and mid-January 2022) put votes in favour in independence at 50% and against independence at 50%. Indeed, support for the two sides has been oscillating around the 50:50 mark for the last three years.

Figure 1: Independence referendum vote intention since the EU referendum



Source: What Scotland thinks. Note: Based on polls that asked how people would vote in response to the question, 'Should Scotland be an independent country?'. Those saying 'Don't Know' or 'Would not vote' excluded.

Does this signal that there has been a change in how Scots view the economic consequences of independence?

Only a few polls have more recently asked the same question about the economics of independence as they asked before the 2014 referendum. But those that have done so suggest that there has only been a marginal shift in voters' outlook.

YouGov reported in January 2020 that 34% now believe that Scotland would be better off if it were independent (down three points on 2014), while 42% felt it would be worse off (a drop of five points). Similarly, Opinium reported in September 2021 that 35% (down two points) now thought that independence would benefit the economy, while 40% (a drop of five points) believed it would be damaged.
In short, at most there has been a slightly bigger drop in the proportion of voters who now have a negative assessment of the economic consequences of independence than there has in the proportion who take a positive view. The biggest difference is the growth of those who say that independence would not make much difference (or say they don't know).

That said, there are other recent polls suggesting that voters are rather more optimistic about the economic consequences of Scottish independence than these results imply.

In September 2020, JL Partners suggested that those who agreed (40%) that 'Scotland's economy would be stronger as an independent country' matched the 39% who disagreed. The previous month, Panelbase found that as many as 48% agreed that 'independence would be good for Scotland's economy', while only 38% disagreed. Meanwhile, in October 2020, Survation reported that 45% agreed that 'independence would be good for the Scottish economy in the long run', while 34% disagreed.

But how questions are asked in polls matters. It should be noted that each of these questions invites people to indicate whether they agree or disagree with a pro-independence proposition. One of the potential pitfalls with this approach is that people are more willing to agree than they are to disagree with more or less any proposition (Krosnick, 1999).

Indeed, one indication of this tendency lies in the fact that when JL Partners presented the same respondents in September 2020 with the pro-Union proposition that 'Scotland's economy would be stronger in the United Kingdom', there were clearly more (45%) who said they agreed than stated that they disagreed (34%).

What other issues will inform voters' decisions?

Still, we should remember that the choice that would be put before voters if Scotland were to have a second independence referendum would not simply be whether they are for or against independence. They would be asked to compare the anticipated consequences of independence with those of being part of the UK.

While, on balance, voters may still be inclined to be pessimistic about the consequences of independence, they may not be that optimistic about Scotland's economic prospects as part of the UK either. Indeed, while in their September 2020 poll, JL Partners found that voters were inclined to the believe that if the country became independent, Scotland's economy would go down rather than up over the next ten years (by 39% to 34%), they also took the view – by 41% to 22% - that the same would happen if Scotland remained in the UK.

As a result, we should perhaps not be surprised that when voters are invited directly to compare the economic prospects of independence and being part of the UK, more than one poll has found voters to be more or less evenly divided.

In JL Partners' September 2020 poll, 43% said that Scotland's economy would be better if it were an independent country, while 43% indicated that it would be better of Scotland were part of the UK. Similarly, Hanbury Strategy found in February 2021 that while 35% thought that the economy and taxes would be better as part of the UK, 35% stated that they would be better in an independent Scotland. Perhaps of equal note is that as many as 30% said that it would not make much difference or that they did not know which would be better.

The referendum vote for the UK to leave the European Union (EU) in 2016 has added another dimension to a possible referendum on Scottish independence. The choice is no longer simply between independence and the Union.

Rather, given the continued opposition of the Scottish National Party (SNP) to Brexit, we can anticipate that any second referendum would be framed as a choice between an independent Scotland that would seek to rejoin the EU and a Scotland that was part of the UK but still outside the EU.

There is little doubt that whatever their views about the economics of independence, voters in Scotland are pessimistic about the consequences of leaving the EU (see Curtice and Montagu, 2020). For example, in March 2021, YouGov found that 52% believed that Brexit had already had a negative impact on Scotland's economy, while just 5% said that it had had a positive impact.

Even among those who had voted 'No' in 2014, 43% said that it had had a negative impact. Meanwhile, only 22% told Panelbase in January 2021 that they thought Scotland would be financially better off as a result of Brexit, while twice as many said that the nation would be worse off. Again, the latter figure included 42% of those who voted for Scotland to remain part of the UK in 2014.

As a result of this pessimism about Brexit, when voters are asked to compare the likely consequences of Scottish independence with those of Brexit, independence does not always emerge as the less attractive prospect. In October 2019, Panelbase found that 45% thought that Scotland would be better off economically as an independent country within the EU, while just 35% thought it would be better off as part of the UK outside the EU.

The following month, another Panelbase poll found that 45% thought that independence would 'offer a greater opportunity' to the Scottish economy than Brexit, while only 24% took the opposite view. Moreover, when asked which option would pose the greater threat, slightly more said Brexit (39%) than independence (37%). At the same time, when in October 2020, Survation asked whether 'independence would be more damaging to the Scottish economy than Brexit', slightly more said that they disagreed (39%) than indicated that they agreed (37%).

Conclusions

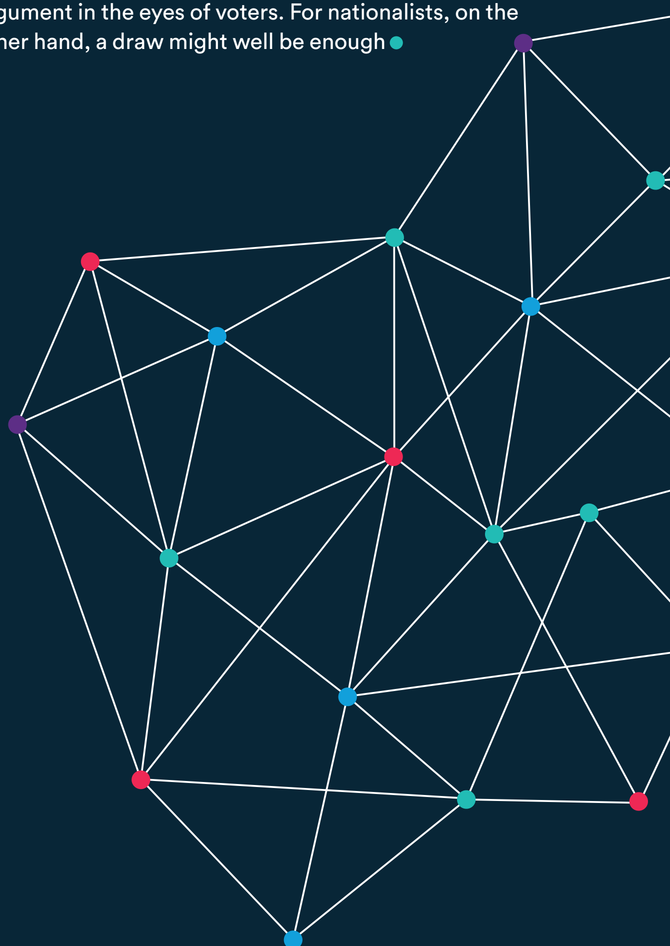
Overall, then, the evidence suggests that there may still be slightly more who are doubtful than hopeful about the economic consequences of Scottish independence. But this is not necessarily robust against an invitation to compare the economic consequences of independence with the prospects for Scotland's economy as part of the UK, and especially when respondents are reminded that being part of the UK means remaining outside the EU.

At the same time, we should remember the observation that many voters currently say either that they do not know what independence might bring or that they are inclined to think that it will not make much difference.

This is potentially a crucial group. Contrary to what one might anticipate, these voters are not evenly divided between those who support independence and those who back the Union. Rather, according to Opinium, they are nearly two to one in favour of Scotland becoming independent – just as they were in 2014.

For some voters, the feeling that independence will not make much difference either way may well be enough for them to back independence – much as it was enough for some people to vote in favour of leaving the EU in 2016 (Curtice, 2017).

If a second referendum on Scottish independence were called, unionists would need to win the economic argument in the eyes of voters. For nationalists, on the other hand, a draw might well be enough



Next steps.

/ Nicola McEwen / Graeme Roy /

Debates about the economics of Scottish independence tend to stir strong emotions, tapping into the fears and sometimes the hopes of those who may be invited to determine Scotland's future.

The contributions to this publication provide a dispassionate look at some of the big economic questions surrounding the future of Scotland and the UK.

Unsurprisingly, they span issues that dominated debates during the independence referendum of 2014, including Scotland's currency options and fiscal position. The contributors also highlight the new economic context that has emerged in the wake of Brexit and Covid-19, as well as fiscal challenges both for devolution and for independence, including trade across Scotland's borders.

Some issues received insufficient attention in 2014, but would be vitally important in a transition to independence. These include the economic institutions required by an independent country.

Historical and comparative insights offer a fresh perspective on the independence question. Some countries have gone through major constitutional change and emerged as prosperous economies. But their experience suggests that change isn't straightforward: benefits can take many years to materialise, and risks need to be managed.

The economics of independence were a central concern in 2014 – and opinion polling suggests that these issues will once again play a crucial role in future debates.

It is in this context that institutions like the Economic Observatory can inform debate, by providing balanced and reliable analysis of key economic issues. This means pointing out where economic research can provide insights, but also being upfront about where economic outcomes are inevitably uncertain.

Debates about Scotland's constitutional future will always be heated. This publication demonstrates the ability of the research community to shed light on key issues to inform these discussions.

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