



Strathprints Institutional Repository

Gallagher, J.D. (2014) *The economic case for union*. Fraser of Allander Economic Commentary, 37 (3). pp. 67-79. ISSN 2046-5378

Strathprints is designed to allow users to access the research output of the University of Strathclyde. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. You may not engage in further distribution of the material for any profitmaking activities or any commercial gain. You may freely distribute both the url (<http://strathprints.strath.ac.uk/>) and the content of this paper for research or study, educational, or not-for-profit purposes without prior permission or charge.

Any correspondence concerning this service should be sent to Strathprints administrator: <mailto:strathprints@strath.ac.uk>

The Economic Case for Union

Professor J D Gallagher CB FRSE Gwylim Gibbon Fellow, Nuffield College, University of Oxford

1 Introduction

It is not surprising to find this journal debating the economic consequences of independence. More surprising perhaps has been how economics has dominated the referendum debate. While one might not take at face value the repeated evidence that voters would support independence only if it made them £500 a year better off¹ the choice of nationhood appears to be a remarkably instrumental one. Certainly whether Scotland would be worse or better off as a separate state is, according to the Scottish Government, the most important question. Naturally, they say Scotland would be better off. Independence, however, is an uncertain business; a new state might gain new freedoms but would lose present sources of stability, and some questions about independence are simply unanswerable in advance. It is nevertheless possible to draw some conclusions about its possible economic effects, and how it would measure up to the criteria set out in Goudie (2013), though his '6 tests' do not address all the relevant questions.

Today, Scotland is a successful part of the UK economy and a very strong case can be made that maintaining the union is in Scotland's best economic interest. This case rests on the foundation that the UK is a well-developed economic union, with a single domestic market, in which goods and services, capital and labour can move freely to take up opportunities, unhindered by international boundaries and not distorted by regulatory arbitrage. It is also a well-functioning fiscal union which, together with an effective banking union, supports both a single currency and a system of social solidarity that promotes social cohesion. The UK pools economic and other risks, (whether banking crises, natural resource revenues or longevity trends) and so absorbs economic shocks. An independent Scotland would have to manage these in other ways, and that would require a painful transition to a different approach to economic management.

The possibility that Scotland might in the long run be more successful as a separate state than within the UK cannot of course be completely ruled out: there are simply too many uncertainties to be sure about that. Yet three things can be said with reasonable confidence. First, the particular version of limited economic independence promoted in the White Paper² is unlikely to be a sustainable way forward, and the alternatives in relation to currency, are unpalatable. Second, an independent Scotland would face immediate and very substantial fiscal challenges. Third, whatever the very long term economic trajectory of an independent Scotland might be, there would inevitably a period of transition during which Scotland would be worse off. That could last for many years, conceivably even decades.

¹ SSA (2014) found that 52% of voters would support independence to be £500 a year better off, but only 15% would if they were £500 worse off.

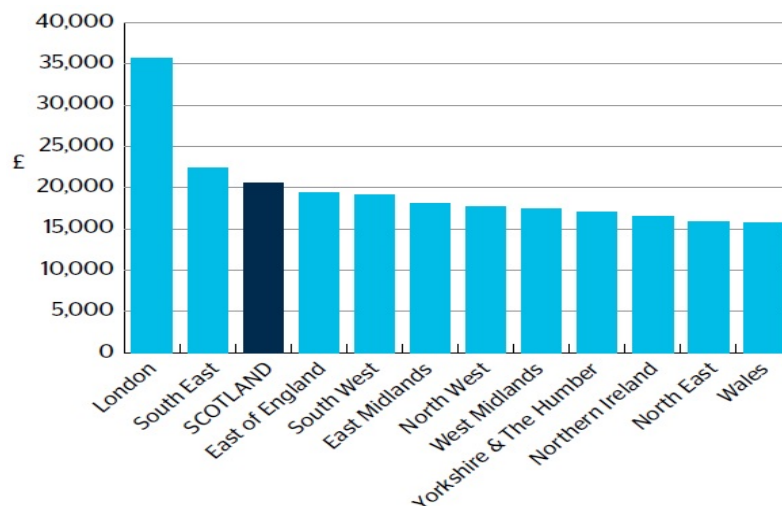
² Scottish Government (2013).

2 How is Scotland doing economically?

It is important to begin with an understanding of Scotland's economic performance as part of the UK.

There are two frames of reference here. In recent decades, much discussion has concentrated on how Scotland was faring compared to the rest of the UK, with an implicit assumption that London and the South East of England were growing at Scotland's expense (and that of the rest of the country). This is linked in political debate to the historic decline of Scotland's traditional economic base and London's success as an international city. Present data, however, do not bear out this picture. Despite undoubted problems, Scotland is one of the richest regions of the UK. Gross per capita domestic product (onshore i.e. ignoring economic activity in the North Sea) makes Scotland the 3rd richest region of the UK, as shown in Figure 1.

Figure 1: Gross Value Added per head, by UK regions



Source: Office of National Statistics, Regional Gross Value Added, 2011.

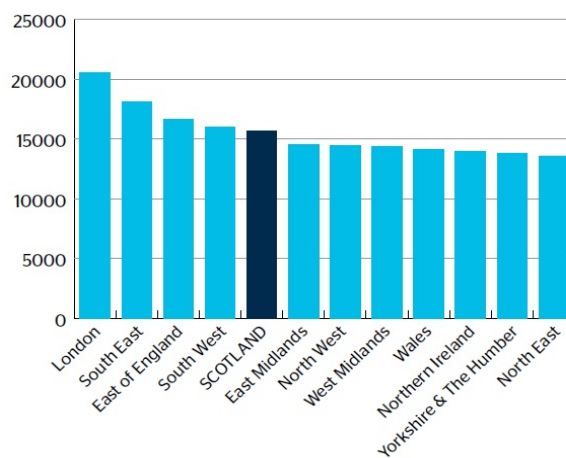
Data on household income by UK region tell a similar story, refer Figure 2.

London remains an outlier for the whole UK, but economic activity in Scotland's largest cities comes surprisingly close to its level, as shown in Figure 3.

A consistent theme in the discussion of the Scottish economy is that growth in Scotland does not match, indeed lags behind, growth in the UK as a whole. This however is principally driven by relative population growth, as the population of England has gradually grown over recent decades, whereas Scotland has been flat by comparison, even though it has recently reached a new high. It is income and economic activity per head which matter most for economic welfare. In fact, Scotland's economic growth *per head* has matched or exceeded the UK's over a prolonged period, albeit by a small amount.

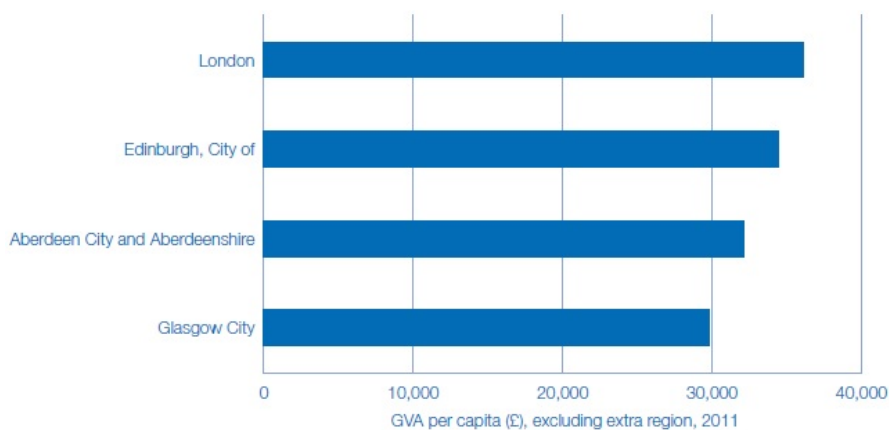
As can be seen from Table 1, during all periods from 1963 to the present day – with the significant exception of the 1980s³ – Scotland's *per capita* economic growth exceeded that of the UK as a whole. Taking the whole period for which data are available, Scotland has a small lead over the rest of the UK in per capita growth terms. It is this lead which means that Scotland now enjoys levels of economic activity at 98% of the UK level, higher than most of England, having started in 1963 at a much lower level. (Of course if offshore activities were included, Scotland, within the UK, would look very much more economically successful. But this is simply a book transfer, as no one would be a penny better off. Similarly claims that an independent Scotland would be very much richer simply as a result of including the North Sea in its economic books is a trivial statistical trick).⁴

Figure 2: Household Income, by UK regions



Source: Office of National Statistics, Regional Gross Disposable Household Income 2011

Figure 3: Economic performance of Scotland's cities and London



Source: ONS, Regional Gross Value Added (December 2012)

³ The 1980s was of course very significant in political as well as economic terms, forming the opinions of much of the Scottish political class, as well as a significant proportion of its economists.

⁴ Of course an independent Scotland would have access to tax revenues from the North Sea; whether this is overall a plus or minus is discussed below.

The UK is about the sixth largest economy in the world, but not the richest country. According to OECD data, UK GDP in purchasing power terms is above the EU, Euro area and OECD averages, and ahead of France, Italy and Spain though behind Germany and some (but by no means all) small European states. So it might be argued that Scotland should instead compare itself with successful small countries. Indeed the Scottish Government set a target of Scotland's economic performance matching that of small independent European nations (the following 7: Austria, Ireland, Denmark, Finland, Sweden, Portugal and Luxembourg).⁵

Table 1: UK and Scottish growth rates 1963 to present (onshore)

	Growth in GVA per head					
	1963-2012	1963-1970	1970-1980	1980-1990	1990-2000	2000-2012
Scotland	2.2%	3.7%	1.7%	2.5%	2.9%	1.1%
UK	1.9%	2.4%	1.5%	2.5%	2.2%	1.1%

Analysis of these comparators⁶ gives a more mixed picture. In terms of GVA per head, Scotland is above Denmark, Finland and Portugal, but behind Austria, Sweden, and Ireland. (Ireland's data however is distorted by multinationals booking profits there for tax reasons, meaning that gross national income is 20% lower than GVA, but no reliable series of GNI data for Scotland is available to make a comparison.) This analysis⁷ looks at historical trends and shows that in recent decades Scotland has had an economic growth rate similar to all the chosen countries. In the labour market Scotland compares quite favourably to them, with relatively high employment rates, and slightly better than average unemployment. No evidence has been adduced for the existence of a 'small country effect' in relation to economic growth: an extensive literature has failed to demonstrate any meaningful correlation. (See eg Rose 2006.) More interestingly, one might expect the volatility of small economies to be greater and Scotland's economic position has indeed in recent years been less volatile than the comparator countries, for reasons discussed below.

3 The significance of economic union: free trade

It is fair to conclude that, overall, Scotland's economic performance is very good by UK standards, and good by comparison with the Scottish Government's own benchmarks. So, what is it about an economic union that achieves these results?

The union of 1707 was, in the words of one of the Commissioners, motivated by "trade with most, Hanover with some".⁸ Hanover was code for the Protestant religion, which was immediately secured. It did however take some time for the benefits of trade to become obvious; Jacobite wars did not help.

⁵ *Scottish Government (2007): though Luxembourg is an odd comparator: it is a statelet with a smaller population than Glasgow.*

⁶ *HM Government (2014)*

⁷ *HM Government (2014), p.30*

⁸ *McLean, Gallagher and Lodge, (2013), page 171*

Nevertheless the UK has become a single market in all meaningful senses. There are no tariffs and few if any non-tariff barriers. Despite Scotland's different legal system, commercial law is substantially uniform. Company law and employment law are set out in UK statutes. Business taxation is uniform. Regional policy interventions over business location are much more limited than in the 1960's and 70's.

The result is free trade. This is taken for granted, but the UK domestic market is a much better functioning single market than any international free trade area. The comparison with the European single market is instructive. Substantial non-tariff barriers remain, eg in financial services. As a result, levels of trade, investment flows and movement of workers between Scotland and the rest of the UK are completely unhindered. This can be seen in patterns of settlement. 830,000 Scottish people now live in the rest of the UK, and 450,000 born elsewhere in the UK live in Scotland.⁹

It can also be seen in patterns of trade. Scotland's biggest customer for exports by far is the rest of the UK. Indeed, Scotland has specialised in certain markets serving the rest of the UK. Two examples will suffice. Scotland is the biggest hub for financial services in the UK outside of London, with an estimated 200,000 jobs dependent on the sector. 90% of the customers of these businesses are elsewhere in the UK. Similarly, Scotland builds the UK's warships. As it happens, both of these sectors would be significantly affected by the creation of an international border. Financial services is highly regulated, and although services can in principle under EU law be provided cross-border, it is likely that providers would wish to relocate to the regulatory domain which contained the majority of their customers; the regulator there would agree. Similarly, if they can, countries tend to buy defence equipment from within their own borders, and this has long been the UK policy for warships.

These are very direct examples of border effects on trade. But border effects are much wider. How significant they are is a matter of some dispute, and will undoubtedly depend on the detailed circumstances and previous history. It is clear, however, beyond all doubt that erecting an international border will, other things being equal, reduce trade, not increase it. Estimates by the UK government calculate this effect as reducing real income by 4 per cent after 30 years.¹⁰ Independence would have to lead to marked increases in economic activity to offset this. How it would do so has not been explained.

In short, a single UK market promotes opportunity in trade, employment and capital flows, and if Scotland becomes a separate state, this market will be hindered and economic welfare suffer accordingly. This is surely indisputable: if such border effects did not exist, nations in Europe, North America or elsewhere would not be negotiating to deepen free trade areas.

4 The significance of economic union: risk management

Free trade offers an argument from economic opportunity: by contrast, economic integration offers one from economic security. Larger economies tend to be less volatile, as risks and shocks are absorbed over a wider pool. Here comparison with the Scottish Government's selected group of small countries is instructive. Because Scotland is an integral part of a larger economy it showed markedly less volatility in

⁹ Governor Carney noted (Carney 2014, p.5) that flows at present were not especially high, but that the economic and social similarities meant they could easily grow in size if need be.

¹⁰ HM Government (2013), p.52. This number could in fact be significantly higher depending on the exchange rate regime adopted. See, for example, Engel and Rogers 1996.

the recent financial crisis than small, independent EU countries even though it has a large financial services sector-. The UK Government's analysis (HMG, 2013) suggests that the impact of the recession in small economies was greater and more prolonged than on large ones, because of their relative lack of absorptive capacity. The economies of small countries are in general more volatile due to a greater reliance on external trade and the absence of any "inter-regional insurance" in the form of fiscal transfers. Refer Table 2.

Table 2: Impact of the recession on Scotland and small comparator economies

	Timing of the recession			Output impact of the recession		
	Quarter of peak	Quarter of trough	Duration (peak to trough)	Peak to trough(%)	Trough to 2013Q1(%)	Peak to 2013Q1(%)
Austria	2008Q2	2009Q2	4	-5.2	6.5	1.0
Denmark	2008Q2	2009Q2	4	-8.0	2.6	-5.6
Finland	2007Q4	2009Q2	6	-10.4	5.2	-5.7
Ireland	2007Q4	2009Q4	8	-11.5	2.0	-9.8
Luxembourg	2008Q1	2009Q2	5	-6.3	3.9	-2.6
Portugal	2007Q4	2013Q1	21	-8.6	0.0	-8.6
Sweden	2007Q4	2009Q1	5	-7.6	13.1	4.5
Median of comparable countries	2007Q4	2009Q2	6	-8.0	3.9	-5.6
Scotland	2008Q2	2009Q3	5	-5.6	3.8	-2.0

The two most significant mechanisms for this absorption of risk are Scotland's existing monetary and fiscal unions; each follows from having an integrated UK economy. It is helpful to look at each in turn.

5 The significance of economic union: monetary and banking union

UK monetary union followed the 1707 political union (with some ups and downs on the way). Economic theory is settled on the necessary conditions for a successful monetary union: a genuinely open market, and an economy which reacts to external shocks in broadly the same way. Recent experience of the Eurozone in particular demonstrates two further requirements, as set out in Carney (2014): sufficient fiscal integration that allows fiscal flows to offset the effects of economic shocks to growth, and a sufficiently integrated banking system to ensure stability across the area. The UK meets these conditions; the Eurozone is seeking to move in that direction.

As a result the UK Government was able to rescue the Scottish banks in 2008, even though they were bigger compared with the Scottish economy than banks in Ireland. In the UK, neither depositors nor bondholders lost their investments, unlike in Iceland. This sharing of risk in a larger economy is seen in the reduction in economic volatility in Scotland compared to small European countries shown above. Refer Table 2.

But as Governor Carney pointed out in his careful lecture, a successful banking and monetary union also requires fiscal union. In his view successful currency unions have a national or supranational authority

able to address economic imbalances as they arise by having direct fiscal control over about 25% of GDP. This implies some form of fiscal union.

6 The significance of economic union: fiscal sharing

Fiscal sharing is needed for two reasons. First, bank rescues are not only about the provision of central bank liquidity. Ultimately they rely on governments, ie taxpayers, standing behind institutions, providing capital if needed. In a fiscal union like the UK, this happens automatically, without question, and it is not subject to slow and painful intergovernmental negotiation, as in the Eurozone. The UK has been a fiscal union for so long it is taken for granted that public resources flow in such circumstances irrespective of geography or nationality. It is very hard to see how they could do so after separation into two states: this has now been made plain by the Chancellor of the Exchequer, and the other political parties, in their ruling out of a post-independence currency union.

Secondly, 'horizontal' fiscal transfers can ensure that if one part of a currency union experiences a negative shock, the strain of adjustment (which, absent currency union, would be met by exchange rate adjustment) is met by the transferred resources. Typically such transfers might be increased unemployment insurance payments, or support for public services. It is the absence of such payments in the Eurozone that means that countries like Greece struggle to provide either: without fiscal union, spending is determined by local taxable capacity. (Fiscal transfers between independent states are called international aid, or in the EU 'structural funds': neither is automatic or continuing.) By contrast, in the UK, transfer payments such as pensions and welfare benefits are blind to geography: they depend only on individual circumstances. And meeting needs – however imperfectly measured and recognised – is the watchword for the geographical distribution of spending on services.

This has significant consequences. First, there is a much greater equalisation of living conditions in the UK than across many other unions, such as the EU or even the United States. Second, the risks not just of short term shocks but also of long term trends are pooled, so that individual geographies do not have to carry them. So for example those parts of the country which have a high age dependency ratio do not have to have higher tax or lower state pension rates. Similarly, if tax revenues fluctuate in the short or long terms (as for example when oil revenues decline) benefits or public services – and demand in the economy – do not fluctuate in the same way. (As discussed below these fluctuations can alternatively be managed across time rather than geography through borrowing: but that significantly constrains the economic strategy a country can follow.)

7 So what about independence?

It cannot simply be asserted that independence would make Scotland richer. Economic success or failure of an independent state depends on the policies it follows, and indeed, the range of major economic choices it could in principle make (from socialist paradise to capitalist tax haven) is remarkably wide - and there are proponents of independence advocating something close to each.¹¹ That doesn't help make a comparison between being part of the UK and leaving it – excepting the obvious point that

¹¹ See for example the publications of the Jimmy Reid Foundation (<http://reidfoundation.org>) or the Wealthy Nation group (www.wealthynation.org).

independence is markedly more uncertain. It is fair, however, to begin with an assessment of the likely effect of the policies as set out in the Scottish Government's independence White Paper.¹²

The striking thing about the White Paper is not that it claims elements of both socialist paradise and capitalist tax haven; that is to be expected, if deprecated, in a manifesto. What is striking is how limited the form of economic independence proposed is, and how few proposals there are for making and taking the new opportunities set out in the first of the Goudie tests. Critically, it proposes a continued banking and monetary union, but complete fiscal independence. The pound, it proposes, should be shared with the rest of the UK, with some form of Scottish representation on the Bank of England, a hybrid system of financial regulation, but no fiscal sharing.

To the challenge that a Scottish Government cannot guarantee that the rest of the UK would join a union with such an asymmetrical risk profile, their response is it would be in the interests of the continuing UK to do so.

This has been heavily criticised, understandably, as an attempt at political reassurance masquerading as an economic policy. As the Carney analysis makes very clear (like much other commentary) a monetary union without fiscal underpinning would be unstable, and while the advantage of reduced transaction costs is a real one, that would be more than offset by the inability to manage financial or asymmetric shocks.¹³ Given the asymmetry, most of the risks of such an arrangement would be borne by the continuing UK – it is conceivable the continuing UK could bail out Scotland or Scottish banks but not vice versa. There is now a cross-party consensus among the three main UK political parties that such an agreement would not be in the interests of the continuing UK, and they have ruled out the White Paper's proposed monetary union.

Nor is it in Scotland's economic interests. While not having exchange rate uncertainty with Scotland's main trading partner is desirable, the loss of both exchange rate and fiscal transfer mechanisms for dealing with economic shocks would leave Scotland's economy very vulnerable. In these two respects the plans for independence fail, at the first hurdle, the second of the Goudie tests - that a proposed monetary union be stable.

Scottish Ministers resolutely refuse to contemplate an alternative currency strategy. Indeed, they suggest that the threat of defaulting on Scotland's share of the UK debt would bring the rest of the country to heel, given that the UK has already guaranteed to honour all debts. A unilateral refusal to meet obligations might not be the best start in the world of international borrowing for a new state that would still be running a public sector deficit of 2.5% of GDP or more. More immediately, such threats would imperil a stable transition to independence for which UK cooperation over a very wide range of areas is essential.

It makes sense to consider the two main alternatives. One can relatively swiftly be dismissed, even though it has been hinted at by the First Minister – the use of the pound in an "informal" currency union without agreement, and without a Scottish central bank to issue currency. In those circumstances a

¹² *Scottish Government (2013).*

¹³ *A point made in debate by the Institute of Directors, amongst others.*

Scottish government would have very few 'economic levers' (to use the phrase popular with the present administration) - no monetary tools whatsoever, and very limited fiscal freedom.

The alternative – followed by many small countries outside currency unions – is a new Scottish currency, say the pound Scots. If the challenges of establishing it could be overcome, it gives Scotland options. It might be allowed to float or be managed, and perhaps pegged to the pound sterling. Both are possible, but each has implications for economic strategy. A floating currency – especially one linked to the oil price – creates instability in prices, and damages trade through exchange rate risk. A managed currency requires substantial reserves, and a highly conservative fiscal policy to establish sufficient cushions to cope with economic shocks. That is why small countries typically run fiscal surpluses or very small deficits.

In either event, Scotland would have to make a transition to a different economic strategy from the one it pursues today, as part of a larger economy, running substantial deficits. Whether, having made the transition, that different strategy would be more or less successful, is difficult to predict, though the risks are on the downside for the reasons above. The fourth of the Goudie tests - that there should be a well-developed way of managing economic shocks – is failed also, as the White Paper fails to acknowledge that a small open economy has to pursue a different risk management strategy from a part of a larger one.

There is no doubt that the process of transition – particularly if it involved a change of currency, and a shift from deficit financing to running a surplus – would be difficult and painful, especially on top of the fiscal adjustment required anyway. This is, discussed below.

The costs of transition are in no sense trivial. Even the most optimistic advocate of independence would not expect Scotland, as a result of independence, to increase its growth relative to the UK by more than part of a percentage point. As Professor Robert Young has pointed out significant transition costs (especially if a currency change is needed) may absorb many years of the hoped-for increased growth. He notes: "No advanced industrial capitalist state has ever undergone such a breakup, but transaction costs obviously could be very large. In the Quebec case, predictions of GDP losses ranged from about 2 per cent to over 7 per cent."¹⁴

The White Paper proposes few other firm economic policies whose effect might be assessed. The big plan is more state provided childcare to increase parental participation in the workforce. It is possible that this might increase growth; or that the deadweight cost of the policy¹⁵, which is not assessed, would outweigh this. The possibility of a phased cut in corporation tax is discussed, but there is a firm plan to cut Air Passenger Duty. That independence might unleash presently unknown and previously untapped economic potential cannot be ruled out *a priori*, but it seems highly unlikely that cheaper air flights will have that result. The White Paper certainly lacks clear plans for improving Scotland's long term competitiveness, the second Goudie test.

Overall, therefore, the probability of independence under the Scottish Government's model improving Scotland's economic performance, while not exactly zero, cannot be assessed as at all high. The

¹⁴ Young (2013)

¹⁵ the cost of providing free childcare for parents who already pay for it, or for those who do not wish to work

probability of transitional disruption is close to one. This is a very significant consideration, and one that is ignored in the Goudie tests.

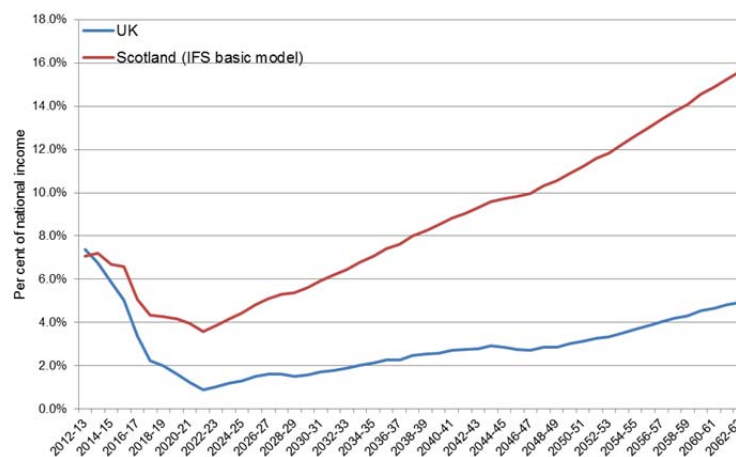
One significant issue, however, is readily predictable: the likely fiscal position of an independent Scotland.

8 Scotland's long-term fiscal position

Scotland's fiscal position inside the UK has been extensively analysed for long periods of time, notably in the Government Expenditure and Revenues in Scotland (GERS)¹⁶, published annually since 1991. The headline story is now well known, if frequently obfuscated. At present, Scottish onshore tax revenues (excluding revenues from North Sea oil) are close to, but slightly under, the UK per capita average. Scottish public spending, including a *per capita* share of 'non-identifiable' spending, such as defence, undertaken on Scotland's behalf by the UK government is just over 10% higher per head. If that were all there was to it, Scotland would be in receipt of substantial horizontal fiscal transfers inside the UK, and likely to run an unmanageably large deficit as an independent country.

Oil makes the important difference, so the future trajectory of oil revenues is the critical consideration. Forecasts vary, as forecasts do, but all agree that there will be a marked downward trend. The most complete analysis has been by the Institute for Fiscal Studies¹⁷, which projected (on the basis of present trends) how Scotland's fiscal position would compare with the UK's as a whole. By 2012/13 oil revenues are no larger than the additional public sector in Scotland, and the striking results are illustrated in the Figures 4 and 5 below. If nothing else changed, Scotland would swiftly run into unmanageable levels of deficit and debt. Even if Scotland was relieved of much of its liability for inherited debt (on what basis it is not clear) and Scottish independent economic policies were more successful than the UK's, something would have to give.

Figure 4: Public sector net borrowing projections for Scotland and UK



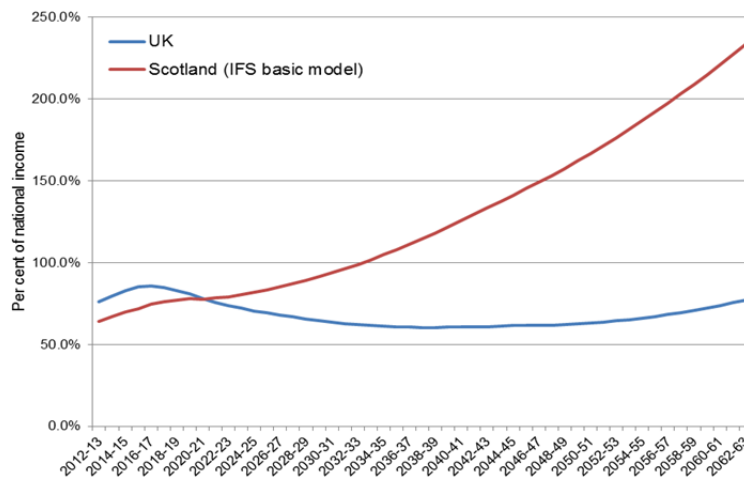
¹⁶ <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS>

¹⁷ Institute for Fiscal Studies (2013), *Fiscal sustainability of an independent Scotland*

Source: Institute for Fiscal Studies, *Fiscal sustainability of an independent Scotland* (with permission)

That ‘something’ would be either higher taxation, perhaps with negative effects on economic growth, or very big cuts in public services. Broadly speaking, in order to reach the same level of deficit as the rest of the UK, the IFS calculate that even on its most optimistic scenario this would require a 9% increase in the basic rate of income tax, or an 8% cut in public services, or some combination of the two. The Scottish Government, however, assert that it would be possible not only to maintain present or better public services and lower levels of taxation but also to put some of the oil revenues into an oil fund. These assertions have been seriously challenged by work such as that of the Centre for Public Policy and Regions at the University of Glasgow.¹⁸ It is hard to escape the conclusion that the Scottish Government’s view is that independence would give Scotland full control over the laws of arithmetic. Certainly these plans fail the fifth of the Goudie tests about risk management: this risk is simply denied to exist, rather than identified and managed.

Figure 5: Public sector net debt projections for Scotland and the UK



Source: Institute for Fiscal Studies, *Fiscal sustainability of an independent Scotland* (with permission)

9 Conclusion

In summary, it is clear that Scotland’s economic performance inside the UK, within the present constitutional model, is creditable. It does very well by UK standards, and well by the standards of other small countries, even those chosen as comparators by the Scottish Government. The model of independence proposed by the Scottish Government is unsustainable and offers no prospect of greater economic growth than at present. It is clearly designed to meet political objectives – reassurance that independence does not involve substantial change – rather than offer a coherent economic strategy for a small country. Partial economic union, while claiming fiscal autarky, is not a sustainable strategy. The White Paper’s strategy would be in the interest neither of Scotland nor of the rest of the UK. It can be assumed, therefore, that it will not be followed.

¹⁸ See for example CPPR (2013).

Although the “Goudie tests” are not a comprehensive set of criteria for assessing the economic effects of independence (e.g. they neglect the very significant issue of transition costs) the White Paper fails to meet them. For political reasons independence is presented as minimal change with low risk, and it fails to address key questions, such as risk and resilience, entirely. The first leg of the sixth, summary, test (“is the proposal economically and financially sound”) is failed resoundingly: the monetary union plan is flawed and already rejected, and the reality of the fiscal arithmetic simply denied. Similarly the absence of substantial economic policy proposals means that its second leg (“enhance the capacity to promote the primary objectives of economic policy”) is not satisfied by the White Paper plans either.

Even if another approach were to be followed under independence, there is no evidence that small countries are more likely to be economically successful than large ones. They are however likely to be more economically volatile, and if it were to be successful as a small country Scotland would have to pursue a different strategy from today: one which would involve coping with economic shocks through running surpluses. The process of adjustment to move from being a country dependent on borrowing (perhaps unwisely, but that is today's reality) to one running a surplus would require structural adjustments to Scotland's economy, taxation and public services. Those would be in addition to the adjustment already being made, and the bigger one needed to move away from dependence on oil revenues to finance public services is set out very clearly in the work of the IFS in particular. No reliable estimate of these transitional costs has been made, but it is plain that they could vastly outweigh any plausible putative benefit of increased economic growth even over a very long period. It is certainly very hard to see that the two economic policy changes advocated by the Scottish Government in its White Paper – namely a possible cut in corporation tax, and cutting air passenger duty – are tools equal to this challenge.

The preservation of the union with the UK is overwhelmingly in Scotland's economic interest, and the burden of proof lies on those who propose to end it. That is not to deny, however, that major economic challenges remain. Scotland's rate of business creation is still persistently low. Scotland's tail of inequality is not merely a narrative of injustice, but one of lost economic opportunity, for individuals and the country as a whole. More needs to be done to address these problems, but many (if not all) of the tools are already in Scotland's hands, in the form of the powers exercised under devolution by the Scottish Parliament.

References

- Carney, Mark (2014), The Economics of Currency Unions
www.bankofengland.co.uk/publications/Documents/speeches/2014/speech706.pdf
- Centre for Public Policy & the Regions (CPPR), (2013), Analysis of Scotland's Past and Future Fiscal Position www.gla.ac.uk/media/media_273150_en.pdf
- Engel, Charles and Rogers, John, (1996), How wide is the border? American Economic Review, 86, 112-25.
- HM Government (2013), Scotland Analysis: Macroeconomic and Fiscal Performance
www.gov.uk/government/collections/scotland-analysis
- HM Government (2014), Scotland Analysis: Assessment of a Sterling Currency Union
www.gov.uk/government/collections/scotland-analysis
- Institute for Fiscal Studies (2013), Fiscal sustainability of an independent Scotland
www.ifs.org.uk/publications/6952
- McLean, Iain, Gallagher, Jim, and Lodge, Guy, (2013), Scotland's Choices, Edinburgh University Press, Edinburgh
- Rose, Andrew K, (2006), Size really doesn't matter: In search of a national scale effect Journal of The Japanese and International Economies, 2006, Vol.20(4)
- Scottish Government (2007), The Government Economic Strategy
www.scotland.gov.uk/Publications/2007/11/12115041/0
- Scottish Government (2013), Scotland's Future
<http://www.scotland.gov.uk/Publications/2013/11/9348>
- SSA, (2014) Scottish Centre for Social Research, Scottish Social Attitudes Survey 2014,
www.scotcen.org.uk/
- Young, Robert (2013), The road to secession: Estimating the costs of independence in advanced industrial states
<http://blogs.lse.ac.uk/europpblog/2013/12/05/the-road-to-secession-estimating-the-costs-of-independence-in-advanced-industrial-states/>

Author details:

Professor J D Gallagher
University of Oxford
jim.gallagher@nuffield.ox.ac.uk