

Would Scotland be economically better off as an independent country? Since the discovery of large deposits of oil and gas off the Scottish coast this question has been an important part of the political debate. We republish here C. R. Smallwood's controversial article in which he stated the economic case against independence. When Smallwood's article appeared in the *Scotsman* it led to a prolonged and diverse correspondence. One of Smallwood's most convincing antagonist was Professor D. I. MacKay. Professor MacKay has restated his argument for us and we have given each the chance to reply to the other. So the main articles are followed by two postscripts. We are grateful to the editor of the *Scotsman* for his permission to reprint the original article.

The Economics of Independence

C.R.Smallwood D.I.MacKay

One of the most striking aspects of the political debate in Scotland at present is the commonly held belief that — whether or not independence is desirable on other grounds — Scotland would be much better off economically if she opted for independence.

The Nationalists, of course, have a vested interest in arguing that if only there were a Scottish Government, with access to the untold riches of the North Sea, Scotland's economic difficulties would soon be over. What is more surprising however is that the major political parties in Scotland have not yet presented any systematic rebuttal of the Nationalists' economic case.

From the point of view of the Government's devolution proposals, it is unfortunate that such a rebuttal has not been made. For as long as the view prevails that independence would bestow enormous economic benefits on Scotland, it is inevitable that whatever the devolution White Paper contains, it will be regarded as an inadequate response to Scotland's needs

and aspirations. If those proposals are to receive a fair hearing, therefore, it is essential to take a clear and dispassionate look at what, in economic terms, independence would really entail.

The fact is that a serious analysis of the economic prospects of an independent Scotland does not indicate that in economic terms independence is clearly Scotland's best option. The economic gains which independence might bring would be much less than commonly imagined, and the economic costs and difficulties and risks, hardly ever mentioned, would be considerable. Consequently, there is no necessity for those people who are Scottish and who wish to remain citizens of the UK to concede the economic argument to the other side. The purpose of this article is to explain why any analysis of the economic consequences of independence has to come to terms with a number of basic questions. Granted that Scottish independence would have to be negotiated, what would the terms of an independence settlement be? Would Scotland remain a part of the UK monetary union, or would there be a separate Scottish currency with its own rate of exchange? How much would the oil revenues really be worth? While we cannot give definite answers to these questions, it seems reasonable to make the following suppositions — which are, if anything, rather favourable to the separatist case.

Oil: No one knows what will happen to oil prices in the coming years. There are persuasive arguments both ways. It is reasonable therefore to think in terms of a constant price, and consequently to have in mind a figure of £3,000 million for North Sea oil revenues.

Division of oil revenues: While international legal conventions would seem to give Scotland most of the oil, independence would have to be negotiated, and essential UK interests would be involved. Moreover, the UK Government now has "joint participation" with the oil companies in the development of the oilfields, and any independence settlement would have to involve a guarantee by Scotland to provide a "fair return" to the rest of the UK in recognition of its capital stake. For these reasons, the Scottish Government would do well to receive two-thirds of the oil revenues, and this is what is assumed here.

Monetary union: While there would be pressures to maintain the monetary union, so that it might survive Scottish independence, it is more likely that the constraints that this would involve on the freedom of action of a newly independent government would be unacceptable to it. It is more reasonable to suppose that Scotland would leave the monetary union, establish its own monetary system and allow the Scots £ to vary in relation to the UK £.

On this basis, it is possible to trace out the major effects of independence on Scotland's economy.

Balance of payments: If the Scottish Government left the rate of depletion unchanged, it would receive £2,000 million a year in oil revenues and the balance of payments would benefit accordingly. The Government would, however, be under pressure to cut the depletion rate both to conserve the oil, and for environmental reasons. On the other hand, it would be under pressure to deliver many of the benefits which had been promised,

and it would have the oil companies to contend with. It is unlikely therefore that the depletion rate would be halved, as has been suggested in some quarters. A much more modest cut might be made, say 10 to 15 per cent — which would reduce revenues by £400 million per year, leaving an annual flow of £1,600 million.

This figure, however, would not represent the balance of payments surplus; this would be reduced by Scotland's existing "non-oil" deficit. According to the best estimates we have, this has been running at about 10 per cent of Scotland's GDP for some time, which makes it now about £600 million. So Scotland's initial balance of payments surplus following independence might be of the order of £1,000 million, or about 15 per cent of Scotland's GDP.

Rate of inflation: It is unlikely that the payments surplus could be maintained for long, and very likely that Scotland's rate of inflation would begin to rise. On the demand side, while it is not inevitable that the new oil money would cause excess demand to appear, it seems reasonable to suppose that, following independence which had come about because the Scottish people wanted to cash in on an oil bonanza, there would be enormous pressures both for increases in public expenditure and for tax reductions.

The Government might in any case favour the creation of excess demand to raise the rates of employment and growth, and in this case, the inflationary pressures would not be resisted. On the cost side, a huge spate of wage demands could be expected, as different groups in society determined to seize "their share" of the new wealth they had been told independence would bring.

As the price level in Scotland rose, for both demand and cost reasons, and as rising consumer demand caused the rate of importing to increase steadily, the balance of payments surplus would steadily disappear; in effect, the income from oil, at first accruing only to the Government, would be translated into a higher standard of living throughout the country, by the mechanism of social conflict. The gain in income per head, on the basis of the analysis so far, would be about 15 per cent.

Exchange rate: With an initial large balance of payments surplus, the Scottish Government would be unable to prevent the exchange rate rising. It would see advantage in this in helping to control the rate of inflation, but the damage a rising rate or "strong pound" would do to the competitiveness of Scottish industry would also be evident. The Government would therefore wish to restrict the rise in the rate, and would do this by arranging for or permitting the export of capital — i.e. investing oil revenues overseas — and this would further reduce the overall balance of payments surplus.

In so far as oil revenues were invested abroad, they would, of course, not be available to raise incomes in Scotland: the figure to have in mind as an indicator of the likely gain in incomes per head as a result of independence is therefore much less than 15 per cent.

Employment: It is fair to anticipate a rising level of internal demand following independence, both because of the inflationary pressure and because of deliberate Government policy. This would be helpful for

business and employment. But most of Scottish industry does not serve the Scottish market. Most Scottish goods are sold in the English market and overseas. Following Scottish independence, the rest of the UK would be depressed and demand for Scottish goods there would be low. Moreover, the position of Scottish industry in English markets would never wholly recover as the UK £ floated down and the Scots £ floated up.

As for overseas markets, as the Scots pound floated up (augmented by the rising inflation rate), Scottish industry would continue to lose competitiveness, and its existing rate of decline would be speeded up. Thus following independence there would soon develop a chronic problem of structural unemployment, not amenable to Keynesian measures because of the openness of the Scottish economy. The rate of job losses might easily rise to 35,000 a year, at which rate it would only take three years for unemployment in Scotland to rise to 10 per cent.

Investment and growth: Some of the supporters of separatism argue that a Scottish Government with access to oil revenues would be able to "regenerate" the Scottish economy, so that there would be dynamic gains to add to the once-over gain in income per head which has already been mentioned. It is important to consider of what order such "dynamic gains" might be.

The Scottish Government might seek to raise the rate of investment by increasing the level of internal demand and raising the rates of assistance to industry at present given under the regional policy. The limited effect of raising the level of demand in the Scottish economy has already been explained. As for attracting new industry by raising rates of assistance, the rising exchange rate would make Scotland an unattractive location for mobile industry serving markets in England or the EEC, and assistance would have to be increased substantially simply to maintain the present position.

If, nevertheless, it is conceded that these measures might have some effect in raising the rate of investment, it remains true that according to the best evidence we have, the rate of investment has to be raised a great deal (say 50 per cent) in order to raise the growth rate a little (say 1 per cent). It is rational to suppose therefore that any increase in Scotland's growth rate following independence would be very small.

So the overall conclusion which emerges from an analysis of the economic benefits and costs of independence is two-fold. On the one hand, there might be an increase in income per head of "less than 15 per cent", depending on the extent to which oil revenues were invested abroad. It might be best to take more explicit account of this factor and think in terms of a gain between 5 per cent and 10 per cent.

On the other hand, considerable costs would be incurred, including damage to Scotland's industrial structure as the rate of decline of Scottish industry speeded up; large-scale structural unemployment; serious inflationary pressure damaging not only Scotland's economy but also the cohesion of its society.

Whatever balance the partisans on different sides of the argument might choose to strike between these gains and costs, it is certainly not obvious

that the Scottish people should regard independence as desirable from the economic point of view, however they regard it on other grounds.

And there is another factor in the background — the risk of economic disaster to an economy dependent for its viability on oil revenues, should the price of oil drift down.

If the independence game really is not worth the economic candle, it should be recognised that it is not, if only so that people can make a fair assessment of the relative benefits contained in the devolution proposals. If independence, because of the costs and risks involved, is not on balance preferable to the present situation, and if devolution offers Scotland economic benefits, then it will be devolution and not separatism which is Scotland's best economic option.

A Rejoinder D.I.Mackay

Major constitutional questions such as devolution, federalism or independence cannot be resolved on narrow economic arguments. Hence, it is not my purpose here to advocate any type of constitutional settlement for Scotland for the following analysis is concerned solely with the comparative economic advantages conferred on Scotland by (a) devolution as currently proposed, and (b) independence.

Christopher Smallwood has suggested that the economic benefits conferred on Scotland by the former are greater than, or at least comparable to, the economic benefits arising from independence. In particular he suggests that the economic benefits arising from North Sea oil and gas production are much less than is commonly supposed. I find his argument quite unconvincing as it rests on the fundamental premise that the Scots would choose an economic policy of almost criminal recklessness. Governments do sometimes act in this way as British citizens know to their cost. However, it is of little interest to argue that misconceived policies will dissipate any advantage. We can all accept that proposition. Of more interest, or at least of more interest to the dispassionate observer, is whether devolution or independence provides a better framework within which to apply **sensible** economic policy to deal with Scotland's economic problems.

It might be useful to begin by stating the area of agreement between Christopher Smallwood and myself. I would accept the following points he raises:

(1) He estimates that on present policies there might be an annual revenue from oil production of some £3,000 million annually by the 1980s.

(2) In the event of Scottish independence some part of oil revenues is likely to accrue to England and Wales. However, it appears probable that the bulk of the revenues would accrue to Scotland and Smallwood assumes that Scotland's share might amount to two-thirds of the total.

(3) Revenue on this scale would result in a massive surplus on the current account of Scotland's balance of payments.

(4) Given the situation described in (1) and (3) the exchange rate would tend to float upwards, making it more difficult for the traditional exporting industries to compete in world markets unless their efficiency could be improved. This process cannot be accomplished easily and an attempt to force the pace would both increase the rate of inflation and the level of unemployment.

All this seems to be quite incontestable. However, the final outcome Smallwood predicts will only arise given the inappropriate policies which he suggests. They do not represent the inevitable outcome of independence. More sensible policies offer the prospect of real economic advantage and we should pursue this rather than the hares let out of the bag by Christopher Smallwood.

First, it is clear that the reserves of North Sea oil and gas are so large that they would remove, for an extremely long period, any constraint on Scottish economic growth arising from an unfavourable balance of payments current account. There is no need at all to allow this to be reflected immediately in a rise in the exchange rate. Smallwood arrives at this conclusion by making an implicit assumption that a Scottish government would follow the same rate of depletion as a British government. This is an extraordinary position to adopt as it implies that a policy suitable for an economy with a population of 55 million is also suitable for an economy one-tenth of that size. Of course, it is not and it should hardly surprise us to find that Smallwood can "prove" such a policy unsuitable. Once this assumption falls the whole of Smallwood's argument collapses, and the assumption must fall for the rate of depletion of oil and gas reserves is not established by divine authority. If a quick rate of depletion yields too large a surplus on current account then the rate of depletion can always be reduced. There is little room to doubt that an independent Scottish government would choose a much lower rate of depletion than that likely to be chosen by a British government. All that we are saying is that as the balance of payments problems of Scotland and Britain would be different, the depletion policies which would be appropriate are also different (compare Norwegian and U.K. depletion policies).

Again, Smallwood pays little attention to the capital account of the balance of payments. A surplus on the current account can be offset by investment abroad. Smallwood argues that, "In so far as oil revenues are

invested abroad, they would of course not be available to raise incomes in Scotland'. This is an extremely shortsighted view. Investment overseas produces a stream of future income which does raise national income. Those familiar with British economic history will understand the process and also the economic benefits it can confer. The use of oil revenues to finance capital investment abroad yielding a future income is one obvious means of spreading the benefits over a longer period. This could secure a favourable balance of payments position for a long period after the oil and gas reserves are exhausted.

In brief, North Sea oil and gas reserves offer the real possibility of "buying time" during which the fundamental restructuring of the Scottish economy can be attempted. The period of time bought can be extended by appropriate economic policies. Of course, it will be extremely difficult to deal with the underlying economic problem for Scotland, like Britain, is an extremely inefficient economy by the standards of Western Europe. Heavy and selective emigration has left Scotland very short of business and entrepreneurial skills, a shortage aggravated by the prevailing emphasis on other skills and professions. Decades of low investment, low labour productivity, restricted labour mobility and abysmal industrial relations are not changed by the acquisition of political independence. However, these difficulties must be faced in any constitutional environment; they are as much a present fact for devolution as for independence.

The crucial fact to grasp about North Sea oil and gas is that the major benefits accrue to central government which has the right to tax North Sea oil and gas production. Smallwood concedes that these benefits would arise to a Scotland with political independence. Certainly they will not accrue within the devolutionary framework currently proposed as this specifically excludes any revenue sharing scheme. Economic growth in an independent Scotland need not be restricted by balance of payments constraints. If one favours a "market approach", as I do, it would be perfectly possible to encourage investment by reducing corporation tax and to reduce the penal rate of taxation, which in present-day Britain inhibits risk-taking and the acquisition of skills. Smallwood appears to think that such measures would make little appreciable difference. For example, he suggests a 50 per cent increase in the rate of investment would raise the growth rate by 1 per cent, which he regards as very small. This appears to be a matter of arithmetic. A 1 per cent increase in the rate of economic growth represents, over any substantial period, a major difference in outcome. If Britain's growth rate over the last three decades had been 1 per cent higher, then it would compare favourably with other advanced industrial countries and we would all be a lot richer. Any reader who is not convinced should consult the compound interest formula and calculate the difference between, say 2 per cent and 3 per cent growth.

In short, independence and North Sea oil do not offer any easy solution to the real economic difficulties involved in restructuring the Scottish economy. It only offers a framework within which there is a good chance that sensible policies might find solutions. There are other constitutional possibilities, but here it must be said that Smallwood is strangely silent on

the economic advantages which will accrue from the present devolutionary proposals. Perhaps this is not surprising as the proposals do not change fundamental economic relationships and will grant to a Scottish Assembly less power to raise its own revenue than that normally accorded to a local authority.

POSTSCRIPT TO THE DEBATE

C. R. Smallwood

Having read Professor MacKay's riposte to my article, I think it can fairly be said that he and I are in broad agreement about the likely economic consequences of independence for Scotland, and that the remaining differences between us are matters of political judgment rather than economic analysis. Perhaps I could illustrate this by making three points.

(1) In my article, I explained that a flood of new oil money into the Scottish economy would cause considerable disruption, and I suggested that anyone wishing to decide whether or not independence was desirable in economic terms would need to weigh the costs of such disruption against the gains in income per head which the oil money would also provide. I quite agree with Professor MacKay that my analysis rested on the assumption that a Scottish government would follow the same rate of depletion as a British government. The reason I assumed this is that it is indeed the policy of the Scottish National Party to maintain a depletion rate in excess of 100m. tons a year, and the purpose of the article was to trace out the economic effects of that policy. If, however, the policy were to be changed, and the new Scottish government were to cut down the depletion rate significantly, or were to invest oil revenues abroad on a large scale, then Professor MacKay and I agree that most of the disruption about which I wrote could be avoided. The corollary of this, however, is that the increase in Scottish national income would be correspondingly less, and would not be such as to justify the economic expectations which the political campaign in Scotland has generated. Too much emphasis should not be put on any particular set of figures, but if for the sake of argument Scotland did receive two-thirds of the oil revenues as I assumed in my article, and if the Scottish government say halved the depletion rate of the reserves it controlled, then after the existing Scottish trade deficit had been financed, the resulting increase in Scotland's national income might be of the order of £400 million to £500 million (1974 prices). This is the equivalent of 7 to 8 per cent of Scotland's GNP, and therefore fails to qualify as the expected bonanza.

(2) I agree with Professor MacKay that this would nevertheless be a gain worth having, and would buy a certain amount of time for restructuring the Scottish economy. But I am more sceptical than he is that the new money would in fact be used for this purpose. It seems to me that in the circumstances of newly won independence, political pressures and

expectations would be such as to cause what new funds there were to be diverted to meet many demands other than that for new industrial investment, so that the new opportunity to restructure Scottish industry would be much more limited than he supposes. But this is a political rather than an economic judgment, and therefore one on which we are entitled to differ.

(3) Where I disagree with Donald MacKay is in his assumption that devolution will not bring any economic advantages to Scotland. Again, the difference between us is one of political rather than economic judgment. My view is that, following devolution, more and more UK resources will be diverted to Scotland. The devolved services and now the Scottish Development Agency are to be financed from a block grant which the Scottish Assembly is to negotiate each year with the UK government. In these negotiations — and especially while the separatist party is enjoying electoral success — the Scottish Assembly will be in a bargaining position of considerable strength, so that it is not fanciful to suppose that the level of expenditure in Scotland, both on the social services and on industrial development, could be pushed up over a number of years by some hundreds of millions of pounds. This, after all, is the great fear of English MPs, and the principal reason why their support for the Devolution Bill may be difficult to secure.

My overall judgment, therefore, which I stress is a political one as much as it is economic, is that the financial and economic gains to Scotland

(i) of independence — assuming now that a “responsible” economic policy is adopted by the Scottish government, involving either a substantial reduction in the rate of depletion of the oil reserves, or heavy investment of the oil revenues abroad, to avoid the difficulties highlighted in my article; and

(ii) of devolution — assuming the block grant system works to Scotland’s advantage in the way it seems likely to; may well be broadly comparable.

ANOTHER POSTSCRIPT

D. I. MacKay

Christopher Smallwood and I may be close to agreement on a number of points, but the differences remain important. We agree that massive oil revenues could be used to sharply raise consumption in an independent Scotland but that, given the limited absorptive capacity of the Scottish economy, this would adversely affect the long-term competitive position of the economy. Again, we agree that raising the level of efficiency of the economy cannot be easily accomplished. Further, we could agree that neither the current devolutionary proposals, nor independence would suddenly and permanently produce a transformation of Scottish living standards. However, I do not believe that the current devolutionary proposals offer any real prospect of such a transformation, even in the long

run. On the other hand, oil revenues, by providing an extremely strong balance of payments position, could allow an independent Scotland to pursue policies which would have a good chance of producing significant long-run economic advantages. Of course there are other constitutional possibilities, but I believe any settlement which does not provide Scotland with some share of oil revenues, and the power to use them effectively, will not create the necessary conditions for a major improvement in economic performance. If a Scottish Assembly or Parliament does not obtain access to oil revenues then the major benefits of North Sea oil will pass Scotland by. This proposition appears to be quite irrefutable and it is difficult to believe that such a situation will prove to be politically stable.