Europe Economics

What Costs would an Independent Scotland Bear in its First Year?

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1 Introduction

Europe Economics has been commissioned by Scotland in Union to assess the additional costs that Scotland would be accruing if it had voted for independence in the referendum of 2014 and was, as planned, preparing to leave the UK on 24 March 2016. For this purpose, we use the latest available data from Government Expenditure and Revenue Scotland (GERS) along with other sources and present our findings in this short report. Not all costs can be quantified. In some cases we have described qualitatively the potential costs that Scotland would have faced on independence.

It should be noted that the report focuses on the potential costs an independent Scotland would have faced in its first year and as such is not an assessment of the overall net outcome of independence over time.[1]

1.1 Data sources used

The method used in this report has been to update estimates produced at the time of the independence referendum, supplemented by our own analysis of the latest GERS figures. To assess the potential costs Scotland would have faced in the first year had it gained independence, we mainly rely on GERS data and prior analysis conducted by Europe Economics on the EU-related impacts of Scotland leaving the UK[2] which includes the costs of adopting the euro, the costs of border controls and the cost of losing the EU rebate. We also draw upon NIESR estimates of the cost of debt financing in an independent Scotland.

In addition, we estimate the impact of lost renewable energy subsidies, the cost of forming and running the independent Scottish government and the cost of losing tuition fee income from other UK students. We use the estimates from Ofgem, the SNP and the Scottish Government to highlight indicative costs for these categories respectively.

1.2 Structure of the report

The structure of the report is as follows.

In Section 2, we first estimate the Barnett formula allocation differential for Scotland. We then estimate various additional costs that Scotland would have faced in the first year if it were to leave the UK. The cost categories include:

- Additional debt financing costs.
- Cost of adopting alternative currency arrangements such as the euro.
- Cost of losing the EU rebate.
- Cost of forming a border with rest of the UK.
- Cost of lost renewable energy subsidies.
- One-off and on-going set up costs of forming the independent Scottish government.

[1] In particular, we observe that there could be various potential economic benefits from independence. For example, some advocates of independence claim that economic policies run specifically for the benefit of Scotland would produce superior macroeconomic outcomes. Others suggest that Scotland might receive income by charging the rest of the UK for Scotland's continued hosting of Trident submarines. Analysis of the monetary gains (if any) from these and other potential sources of benefit lies outside the scope of this report, because this report focuses on costs and because this report focuses on impacts in the first year — we are not aware of a contention that the suggested economic benefits of independence would lead to material gains in the first year.

[2] http://europeanreform.org/files/New_Direction_-_EU-Related_Impacts_of_Scotland_Leaving_the_UK.pdf

- Potential losses in tuition fees from student in the rest of the UK.[3]

In the Section 3, we summarise our findings and conclude.

[3] Note that we do not give our own numerical estimate of the loss in tuition fees but merely focus on the arguments in existing literature on the potential cost to Scottish universities.

2 Cost to Scotland of Leaving the UK

2.1 Lost public expenditure funding distribution from rest of UK

Scotland's higher public expenditure per capita versus the rest of the UK (£12,800 per person vs £11,300 per person) is supported by a spending allocation (including the well-known Barnett Formula[4]) funded from taxes paid at UK level. That means that some of that higher spending is paid for from higher Scottish taxes and the rest comes from higher taxes paid in the rest of the UK.

Scottish revenues, including a geographical share of North Sea revenues, contribute to 8.6 per cent of the total UK revenues i.e. Scotland only contributes around 8.6 per cent of the cost of the expenditure premium it enjoys. Hence, If Scotland had voted for independence it would lose the externally funded 91.4 per cent of that premium, some £1,398 per capita[5] or £7.5bn in total.

2.1 Additional financing costs

At the time of the referendum on Scottish Independence in 2014, the National Institute of Economic and Social Research (NIESR) reviewed Scotland's monetary and financial options and concluded that "Scotland would pay between 0.72 and 1.65 percentage points more than the UK to borrow at a maturity of ten years."[6] This elevated interest rate was associated with

- being a new debt issuer without an established track record of repaying debts;
- being a smaller state (smaller states tend to have an interest premium because their smaller size means they are more vulnerable to economic shocks);
- Scotland running a higher budget deficit, as a percentage of GDP, than the UK.

UK Public Sector Net Debt currently stands at about £1,500bn. Apportioning a proportionate share to an independent Scotland suggests a Scottish share of £125bn. Using these estimates, once all debts were rolled over, we calculate that Scotland would have to incur between £900m and £2.1bn in additional interest costs compared to the current level of debt interest financing. One conceivable scenario would be that independence would be associated with new Scottish issuance of debt to repay its portion of UK debt — in which case the higher interest rate would apply to the whole outstanding debt. However, for our purposes here we assume that initially Scotland would only pay the same interest as there is, already, on the UK debts it inherits.[7] That means that the elevated interest rate would apply only to new debts issued, which would be a combination of the Scottish deficit to be financed plus any of the inherited debt that needed to be rolled over in the first year. We assume that the latter figure would be 5 per cent. As to the deficit, the 2015 GERS data shows that Scotland's expenditure exceeds its revenue by £14.9bn.

[4] The Barnett formula (named after its inventor, the former Labour Chief Secretary to the Treasury Joel Barnett, who devised it in the late 1970s) is a system of grants which dictates how public spending allowances are allocated to the devolved administrations in Scotland, Wales and Northern Ireland. Under the formula, changes in funding (increases or decreases) from the central UK government are allocated depending on population size and which powers are devolved. The typical allocation under has tended to produce about a 20 per cent higher allocation per capita in Scotland than England.

[5] 91.4 per cent of 1,530 is 1,398.

[6] http://www.niesr.ac.uk/sites/default/files/publications/Plan%20B_Final.pdf

[7] This is not a trivial assumption, as bondholders would have to be willing to accept coupon and principal repayment undertakings by the Scottish government in order to accept transfer.

So the calculation for the stock of debt affected by the elevated interest rate is:

5% x £125bn + £14.9bn = £21.2bn.

Hence the additional interest is as follows.

	2014-2015
Affected public sector debt, £m	£21,200m
Additional interest payment of 0.72%, £m	£150m
Additional interest payment of 1.65%, £m	£350m

Note: Europe Economics calculations.

2.2 The EU rebate

It is not clear what an independent Scotland's position would be regarding the European Union. Nationalists claim that Scotland's membership would continue automatically, while others (including the then European Commission President Manuel Barroso) contended that Scotland would be required to re-apply for EU membership.

It is beyond the scope of this paper to attempt to analyse the myriad risks, costs or benefits of an independent Scotland leaving the EU. However, even in the event Scottish membership of the EU had continued unchanged through the event of independence, there would be cost implications in the first year.

One factor is that, after independence, Scotland would no longer have received its share of the UK's EU budget rebate. The UK rebate is highly unpopular among other EU member states and if an independent Scotland had to renegotiate the terms of its EU membership there is no politically plausible scenario in which other member states would have agreed to a Scottish budget rebate. Moreover, like all other Members of the EU, an independent Scotland would have had to contribute to the rest of the UK's rebate. These two elements would have cost Scotland around £525m in total in the first year of independence.[8]

Table 2.1: Cost of lost UK rebate, £m

	2015 Estimates £m
Direct cost of losing the rebate	450
Cost of funding the UK's rebate	75
Total cost	525

Note: Europe Economics calculations.

2.3 The currency exchange costs

Independence from UK would present Scotland with a number of options relating to its currency. At the time of the referendum, the UK government and opposition parties ruled out continuing to share its monetary arrangements with an independent Scotland.

Some commentators, including former SNP leader Alex Salmond, suggested that Scotland would have continued to use Sterling outside the formal jurisdiction of the Bank of England ("sterlingisation"). It is clear that, in practice, this would not have been a path pursued, since it would have forced the departure of any Scottish bank that required last resort lending (i.e. all modern institutions) and might also have been

[8] In 2015 the UK rebate was worth c.£4.4bn. Calculations adapted from the report, "Three EU-Related Impacts of Scotland Leaving the UK" and scaled to reflect Scotland's respective share. http://europeanreform.org/files/New_Direction_-_EU-Related_Impacts_of_Scotland_Leaving_the_UK.pdf

incompatible with EU Membership (since all EU members are required to have a central bank or equivalent institution to participate in cross-border supervision or the rescuing of failing banks).

A second option would be for Scotland to establish its own currency. In this case, it would need to establish its own national independent agencies (such as an independent central bank, revenues and customs office, debt management agency, financial regulator, etc.), and determine an appropriate exchange rate. It would potentially gain from more locally based decision making on monetary policy while facing potential risks from establishing a new currency with associated market uncertainty.

A third option would be for Scotland to join the Eurozone. The Maastricht Treaty obliges EU Member States to adopt the euro upon meeting certain monetary and budgetary convergence criteria and all countries that joined the EU since 1993 have committed to adopt the euro in due course.[9]

It is beyond the scope of this report to consider whether Scotland would have been more likely to join the euro immediately upon independence or whether it would have initially formed its own currency before joining the euro in due course. However, there are identifiable costs which would be associated with either the establishment of a new currency or adopting the euro:

- One-off costs associated with the changeover to the new currency;
- Ongoing additional transaction costs on trade with the sterling area (partially offset by reduced transaction costs with the Eurozone if the euro were adopted)
- Ongoing trade-related costs associated with changing trade patterns.

We have estimated these costs based on a previous research project conducted by Europe Economics on the EU related costs of Scottish independence. Updated, these would amount to £415m in total[10].

Table 2.2: Currency exchange costs, £m

2014-2015	£m
Transaction-related costs	70
Trade-related costs	345
Total monetary on-going costs	415

Note: Europe Economics calculations.

In addition to these impacts, Scotland might have face macroeconomic policy response risks in the first year. These non-monetary costs could have included:

- In the event of euro adoption, policy might have been less appropriate for Scotland's macroeconomic circumstances in the first year, due to Scotland's currently closer business cycle co-movements with the UK, relative to those with the Eurozone, and its much larger size in the UK (and hence influence upon Bank of England decision-making) relative to the Eurozone.
- Constraints on fiscal policy — forcing faster budget deficit reduction than has been required by the UK.
- Costs of adapting to institutional differences between the Bank of England and the European Central Bank (lender of last resort; banking supervisions; monetary policy framework) or formation of the central bank of Scotland.

[9] http://europeanreform.org/files/New_Direction_-_EU-Related_Impacts_of_Scotland_Leaving_the_UK.pdf

[10] Estimate from prior study "Three EU-Related Impacts of Scotland Leaving the UK" and scaled to reflect 2015 value.

2.4 Border control costs

If an independent Scotland joined the EU, it would be likely to have had to join the Schengen area, meaning a Schengen-compliant border would have to be established. Even if Scotland had not joined the Schengen area, the stated ambition of Scottish policymakers has been to pursue a different immigration policy from that of the rest of the UK. That could only be implemented if there were a border.

Establishing a new border would mean investing in infrastructure to form the physical border as well as additional costs in terms of work and travel related time delays on crossing the border and the processing of European arrest warrants. These have been estimated in a prior report by Europe Economics. In the table below, the estimates have been adjusted to reflect 2014-2015 figures. In total, forming a Schengen compliant border would cost Scotland £77m with EU assistance and £104m without it.

Table 2.3: Border control costs, £m

2014-2015	With EU assistance in border investment (£m)	Without EU assistance in border investment (£m)
Cost of Schengen-compliant border operations	10	37
Cost of work-related travel delays	45	45
Cost of tourism-related travel delays	22	22
Cost of processing European Arrest Warrants from UK	0.6	0.6
Total costs of forming a border	77	104

Note: Europe Economics calculations

2.5 Loss of renewable energy subsidies

The renewable energy sector in the UK is supported by the 'Renewable Obligations' regime that requires energy suppliers to source a proportion of their energy from renewable sources. In effect this results in higher bills for consumers.

The UK government noted, at the time of the Scottish independence referendum, that this could have implications for energy prices in an independent Scotland.[11] Scottish producers receive 27 per cent of Renewable Obligation certificates (ROCs) issued across Britain, but only consume 10 per cent of British energy. In effect, then, 17 per cent of the value of the renewable obligations scheme subsidies are transferred from the rest of Britain to Scotland. In the event of Scottish independence, this transfer would probably cease, meaning that either Scottish consumer bills would have to rise correspondingly, or the sector in Scotland would lose a proportion of its subsidy. In either case the total loss to Scotland would be 17 per cent of the value of the ROCs, which in 2014-15 implies a loss of £510m.[12]

[11] http://www.bbc.co.uk/news/uk-scotland-26939252

[12] The total value of ROC's issued was just over £3bn.

2.6 Government set up costs

An independent Scotland would need to set up new governmental departments to deal with functions that are hitherto reserved to the UK. In 2016 the SNP estimated the set up costs for governmental departments to manage newly devolved welfare powers.[13] Welfare constitutes 8 per cent of total expenditure. As of 2015, 41 per cent of total expenditure was not devolved. Therefore the ratio between undevolved expenditure and the expenditure for which we have a one-off cost estimate (welfare) is 41:8 or around 5:1. The SNP estimated the set-up costs for welfare powers-related departments at £200m. So at a ratio of 5:1, we estimate the set-up costs for all non-devolved expenditure at 5 times this level, i.e. £1bn.

2.7 Lost tuition fees from rest of the UK

If Scotland had become independent and became a new Member State of the EU, then it would become forbidden, under EU rules, for Scotland to charge fees to students from the rest of the UK as is done by Scottish universities at present. That is because under EU law "any person holding nationality of an EU member state is entitled to move freely and reside in another member state and in doing so should not face discrimination from the host member state."[14] As Scottish students do not pay fees, and neither do students from other EU countries, students from the rest of the UK would also become entitled to study free of fees in an independent Scotland.

The fee income received by Scottish Universities from students from the rest of the UK has been estimated at £150m.[15]

[13] http://www.snp.org/time_is_running_out_-_the_treasury_need_to_agree_a_fair_deal_on_more_powers

[14] http://www.scottish.parliament.uk/ResearchBriefingsAndFactsheets/S4/SB_14-37.pdf

[15] http://www.telegraph.co.uk/education/universityeducation/10620373/English-students-could-get-free-tuition-at-Scottish-universities.html

4. Conclusion

In this short report, we have estimated the financial cost of independence to Scotland in the first year. The table below shows our estimate of that cost to be about £10.4bn.

Table 4.1: Total financial cost of independence (£m)

	in latest year from which data available
Loss of externally funded component of expenditure premium (e.g. Barnett Formula)	£7,500
Additional interest payments (mid-point of range)	£250
Currency costs	£415
Lost rebate	£525
Border control costs	£90
Loss of renewable subsidies	£510
Government set up costs	£1,000
Tuition fee costs	£150
Total financial cost of independence	£10,440