The economics of home rule: The Scottish play

Scotland could probably go it alone now, but the economics of independence are steadily worsening

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IN THE debate over whether Scotland should be independent, each side has for years lobbed economic grenades at the other. The pro-independence Scottish National Party (SNP) broke into mainstream politics in the 1970s with the slogan, "It's Scotland's Oil". Alex Salmond, Scotland's first minister and SNP leader, calls it "larceny" that revenues from oil and gas production, most of which comes from Scottish waters, have stuffed London's coffers for the past 40 years. George Osborne, Britain's chancellor, retorts that Scotland would be the poorer for secession.

So would an independent Scotland be an impoverished backwater or a land flowing with oil and money? A precise answer is impossible, since Whitehall does not count all of Britain's revenue and spending streams by geography. Scotland gets a block grant from Westminster, but some things, such as welfare and defence, are paid for directly. But a close reading of the figures suggests an answer, which is less dramatic than either staunch nationalists or unionists might hope.

Scotland's accounts of revenue and expenditure, based on Treasury data, show that it is not a ward of the state, grossly subsidised from Westminster. In fact it performs better than all regions outside the south-east of England, and has done particularly well in the past decade (see chart). In 2010-11 Scotland's GDP was £145 billion ($225 billion) including a geographical share of North Sea oil and gas, around 10% of Britain's, with 8.4% of the population.

Historically Scotland has received bigger grants per head from central government than Wales, for example—in part a tacit acknowledgment that it contributes handsomely to oil revenues, which in 2010-11 amounted to £8.8 billion. An independent Scotland would lose that subsidy, but gain the right to collect taxes on hydrocarbons locally. For the moment, Scotland's day-to-day accounts would look little different to now. But the argument does not end there.

Not so long ago, North Sea oil and gas would have made Scotland rich, had the nation been able to seize it. Declassified documents show that, in the 1970s, Treasury officials reckoned Scotland could comfortably have paid its own way—a big reason the government was so alarmed by rising nationalism. The situation is now more finely balanced. And there are four big reasons to question Scotland's longer-term prospects.

Oil and trouble (Salmond's bubble)

The first problem is oil. An independent Scotland would rely heavily on oil and gas—in 2010-11 offshore activity accounted for 18% of GDP. The equivalent share for the whole of Britain was just 1.8%. Norway is even more reliant on hydrocarbons, but it has far more oil and has for over 20 years been setting funds aside for the day the stuff runs out. Britain has no such retirement fund on which an independent Scotland could draw.

The North Sea is gradually running dry. Many fields will stop producing in the 2020s; by the 2040s oil is likely to be dribbling rather than gushing forth. Tax revenues from oil and gas are highly volatile—they are soaring now because commodity prices are high. And if prices fall both production and receipts could plummet because the remaining North Sea oil is pricey to exploit, says Alex Kemp of Aberdeen University. He forecasts that, at $90 a barrel, 23 billion barrels of oil and gas could still be extracted; at $70, this falls to 16.5 billion barrels. Either scenario is possible. The average oil price was $62 a barrel in 2009; in 2011 it was $111.

There are also hidden liabilities in the North Sea. Decommissioning the installations there, most of which are in Scottish waters, will cost more than £30 billion by 2040, predicts Oil & Gas UK, a trade body. Westminster is currently on the hook for more than half that sum in tax relief, a bill it would happily hand over to Holyrood.

The second question over Scotland's future is whether renewable energy could replace oil as a cash cow, as Mr Salmond hopes. Scotland is blustery, but wind power is heavily subsidised by consumers (many of them south of the border) through their bills. Marine energy is still not commercially viable. The anticipated fat profits from renewables could prove as elusive as the fabled Loch Ness monster.

When the battle's lost and won

Scotland's third long-term problem is the state of its financial-services industry. The country has done well out of banking, but in the past five years the problems of having an outsize banking sector have become apparent. In 2008 the British government bailed out Scotland's two biggest banks, Royal Bank of Scotland (RBS) and HBOS, which was acquired by Lloyds Banking Group. These would probably be broken up as part of an independence settlement, not least because many of their assets are English.

But Edinburgh's fortunes as a banking centre would be hard to revive. A small, newly seceded economy would struggle to support a large financial sector, particularly following the financial crisis. Just think of Iceland, whose banks also collapsed in 2008, crippling the economy. Mr Salmond rebuffs the possibility of taking a share of RBS's £187 billion of toxic assets.

Edinburgh's fund management industry, which includes companies such as Scottish Widows and Standard Life, still makes it a financial centre. Yet that bloom is fading too. Since 2007 Edinburgh has slipped from 15th to 37th on the closely-watched Z/Yen ranking of global financial centres, behind Guernsey, Stockholm and Wellington, in New Zealand.

A better bet for continued growth is oil services. There is already a thriving hub of technical firms around Aberdeen. Yet even some of these are being lured south. Petrofac, an American oil services outfit whose British operations are almost wholly oriented towards the North Sea, listed on the London Stock Exchange in 2005 and has its headquarters in London. Several Scottish firms are considering similar moves.

Fourth and most testing for Scotland's future would be the question of its currency. Mr Salmond's hopes of joining the euro have soured—for now he plans to stick with the pound. Yet the euro zone has amply demonstrated the dangers of entering a monetary union without fiscal union. Soothing niceties from Cheshire-cat politicians no longer reassure bond markets—Scotland would pay a premium for being part of a monetary union that could break. It would have no central bank, no monetary freedom and limited fiscal autonomy.

Other bills would rack up even from an amicable divorce (of which there is no assurance). Scotland would take a per capita share of the national debt, reckons Mr Salmond. The tab for decommissioning its nuclear power stations is £4 billion. Other practical questions abound, such as who would pay out pensions agreed under Westminster's auspices—as those of Scotland's teachers and NHS staff currently are.

Such arithmetic calls into question not just Scotland's economic future but its political one. Spending per head is currently 13% more than in Britain as a whole, supplying free university tuition, for example, which is not available south of the border. Welfare spending, which consumes a third of public funds, is 11% higher than in England and is rising faster as a share of public expenditure than any other category. The SNP hopes to extend state paternalism further, promising free universal childcare and more generous state pensions. Public sector employment, already 24% in Scotland compared with Britain's 20%, would presumably increase. Mr Salmond hopes to fund all this by adopting low corporation taxes to pull in investment.

It remains a matter of judgment whether Scotland could go it alone. But after the banking and euro-zone crises, Scotland would be far more vulnerable to shocks as a nation of 5m people than as part of a diversified economy of 62m. There is an irony here: to preserve a distinctively open-handed Scottish social model, staying in the union might be the safest choice.