Centre for Policy Studies

Pointmaker

OIL, FINANCE AND PENSIONS

WHY SCOTS SHOULD SAY NO

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SUMMARY

- In the event that the Scots vote "yes" to independence, Scotland would face three huge risks.
- First, the outlook for North Sea oil revenues has been obscured by a largely irrelevant debate over the quantities of recoverable reserves remaining.
- New data calculated here suggests that the North Sea revenue for the Scottish government would fall from £10.1bn in 2011-12 (but only £5.5bn in 2013-14) to £3.7bn in 2016-17, some £3.2bn adrift of the £6.9bn predicted by the "yes" campaign.
- Second, concentration on currency issues has deflected attention from the probable flight of the critical financial services sector from Scotland under almost any conceivable monetary outcome. By 2016-17, this could leave ex-North Sea revenues (of £47.7bn) about £9.2bn lower than has been forecast by advocates of independence (£57.3bn).
- Third, the rising cost of public sector pensions would be likely to impose significant pressures on a Scottish budget already straitened by declining oil revenues and the probable haemorrhaging of tax revenues from financial services.
- Together, omission of these three factors results in a severe understatement of independence risk, both to Scots in general and to public sector workers and retirees in particular.
- Forecasts set out here indicate that Scottish government revenues in 2015-16 could be £50.4bn, far below the "yes" campaign's own estimate (£64.2bn) and far lower, too, than the £63.3bn that Scotland is expected to spend in that year.
- There is a major risk factor for the rest of the UK ("rUK"), too, in the likelihood of a sharp deterioration in the current account balance, from 5.5% of GDP to over 7%. Unfortunately for Scots, this, too, could have adverse implications for their own economy.

INTRODUCTION

The voters of Scotland are about to decide whether their country will become independent, or will stay a part of the UK.

Though they may not be decisive, economic issues must be a major factor in the independence decision. This report raises three critical questions about independence, questions which call into question the economic viability of an independent Scotland. These issues are:

1. What is the future trajectory of North Sea oil and gas production and tax revenue?
2. What will happen to tax revenues if much of Scotland's vital financial services industry relocates?
3. How onerous will be Scotland's share of the UK's unfunded public sector pension system?

The fiscal implications for 2015-16 are spelled out in Figure 1. With the North Sea shortfall, the assumed slide in tax revenues from financial services and the impact of public sector pensions all factored in to the equation, revenues come out £13.8bn below the "yes" campaign's projections, turning the predicted small surplus into a dangerously large deficit.

A fourth risk is that the loss of Scotland's North Sea oil would move the UK further down the road to insolvency. Most notably, the current account deficit would worsen from an already-unsustainable 5.5% of GDP to over 7% on a pro-forma basis.

The problem with this, from an independence perspective, is to demonstrate how a weakening of Scotland's largest trading partner can conceivably do anything but harm Scotland's own economy, particularly if Scotland intends to continue to use Sterling.

RISK #1: NORTH SEA REVENUES

Though Scotland's exposure to the North Sea oil and gas industry has been discussed exhaustively by both sides of the debate, the focus has been placed overwhelmingly on remaining *reserves*. Industry expert Sir Ian Wood has said that recoverable reserves stand at some 15 bn boe (billion oil-equivalent barrels), whilst supporters of independence have argued for a far larger quantity, of the order of 24 bn boe.

The reality about reserves is in fact conjectural – but it is also not the real issue. What really matters, where tax revenue is concerned, is the relationship between production volumes and extraction costs. The picture here is one of declining production and escalating costs, factors which, together, have already put North Sea revenues on a sharply declining trajectory.

Production is declining rapidly because the North Sea is a mature production province. Of course, new fields continue to be developed to offset falling production from mature sources, but these new fields are orders of magnitude smaller than their predecessors, and orders of magnitude more costly to develop and operate.

Figure 1: Budget projections, Scotland, 2015-16* (£bn, current terms)

	Financial services	Other receipts	Receipts ex-N. Sea	North Sea	PS pensions	Receipts	Public spending	Fiscal Balance
"Yes" case			£57.3	£6.9		£64.2	£63.3	£0.9
This report	£5.4	£42.0	£47.4	£4.0	–£1.1	£50.4	£63.3	–£12.9
Difference			–£9.9	–£2.9	–£1.1	–£13.8		

* For sources, see later tables

Over the last ten years, UK production of oil and gas has decreased by 63%, from 199 mmtoe (million tonnes of oil equivalent) in 2003 to just 69 mmtoe last year. Despite new production being brought on stream, the relentless erosion of production from existing sources continues. Overall output declined by 7.7% last year alone, and, even if this annual rate of decrease slackens to 6%, as is assumed here, volumes are set to fall by a further 31% between now and 2020.

Tax revenues are highly leveraged to this decline, in part because unit costs are rising as supply from smaller, more marginal fields displaces output from older, larger sources.

The likely trajectory for North Sea revenues is set out in Figure 2 below. The view of oil prices used here is a bullish one, and the projections assume that the price of marker Brent crude will rise by 4% annually, from US$109/bbl last year to US$143/bbl by 2020. Were oil prices to remain flat, revenue would fall even further.

Even on the more bullish price assumption, the combination of declining production and rising costs is likely to reduce gross UK North Sea tax revenue from £6.1bn in 2013-14 (and £11.3bn in 2012-13) to £4.1bn by 2016-17 and £3.2bn by 2019-20. On an assumed 90% geographic share, Scotland's North Sea tax income would fall from £5.5bn last year to just £2.2bn in 2019-20.

RISK #2: FINANCIAL SERVICES

Scotland has long punched far above its weight in banking, insurance, investment management and other financial services. According to official statistics, "business services and finance" accounted for 26.4% of Scottish non-oil GDP in 2011, and this proportion has probably increased slightly since then, to about 26.9%.

Figure 2: North Sea oil revenues, 2003-04 to 2019-20 (£bn current prices unless otherwise stated)

£bn	**Production**	**Brent**	**£/$**	**Revenue**	**Scotland**	**Share**	**"Yes"**
Year	**(mmtoe)**	**($/bbl)**		**UK**	**share****	**at $110/b**	**case *****
2003-04	186	$36	1.78	£4.3	£3.9		
2004-05	169	$50	1.82	£5.2	£4.7		
2005-06	152	$62	1.84	£9.4	£8.4		
2006-07	143	$71	1.96	£8.9	£8.0		
2007-08	136	$91	1.89	£7.5	£6.7		
2008-09	125	$71	1.64	£12.9	£11.6		
2009-10	116	$75	1.55	£6.5	£5.8		
2010-11	98	$103	1.59	£8.8	£7.9		
2011-12	83	$112	1.59	£11.3	£10.1		
2012-13	75	$109	1.55	£6.1	£5.5		
2013-14e	70	$112	1.62	£5.0	£4.5		
2014-15f	**66**	**$116**	**1.65**	**£4.8**	**£4.4**	£4.1	£5.8
2015-16f	**62**	**$121**	**1.65**	**£4.5**	**£4.0**	£3.7	£8.3
2016-17f	**58**	**$126**	**1.65**	**£4.1**	**£3.7**	**£3.2**	**£6.9**
2017-18f	**55**	**$131**	**1.65**	**£3.8**	**£3.4**	£2.9	£7.3
2018-19f	**51**	**$136**	**1.65**	**£3.5**	**£3.1**	£2.5	£6.0
2019-20f	**48**	**$142**	**1.65**	**£3.2**	**£2.9**	£2.2	

Sources: HM Treasury, GERS, *BP Statistical Review of World Energy*, *Scotland's Public Finances and the Opportunities of Independence* and author estimates

* Assumed to be 90%

Within this total, it seems reasonable to assume that financial services account for at least 15% of Scotland's non-oil economy.

Their contribution to government revenues is probably even larger than this, not least because financial services is a high-wage industry, a factor reflected not just in taxes on income but also in other levies such as VAT and Capital Gains Tax. It is assumed here that financial services' 15% share of the Scottish economy corresponds to 20% of onshore tax revenues.

Those who assume that the financial services industry would carry on pretty much as before in an independent Scotland are gravely mistaken. For one thing, the Scottish banking sector would lose what amounts to the underwriting of solvency by the Bank of England.

It is worth remembering that the two big UK banks which required rescuing in 2008 were both Scottish; the Edinburgh-based Royal Bank of Scotland and HBOS. Though some non-Scottish institutions were bailed out as well, these banks account for the vast majority of the £932bn intervention debt carried by the Government as of July this year. What this amounts to is that the British state is acting as guarantor for losses of up to this amount. Moreover, it is implicitly understood that a British Government could not, in reality, stand by and watch either of these banks go under, which means that the guarantee is to all intents and purposes limited only by the resources and the creditworthiness of the British state.

Clearly, Scotland alone could not conceivably have bailed out RBS and HBOS, and the view expressed here is that it would be foolhardy to believe that the 2008 financial crisis is incapable of repetition.

In any case, and quite apart from the loss of the Bank of England guarantee, the post-independence climate would not be congenial for the financial services industry. For a start, the currency issue is problematic. In the absence of a currency union, Scotland could of course use the pound, but it is difficult to see how she could borrow in that currency.

Even if borrowing were possible, the sheer scale of Scotland's banking system in proportion to GDP implies that the Scottish sovereign borrower would have to pay a hefty risk premium to borrow.

The same risk premium would attach to borrowing by Scottish financial institutions, placing them at a significant competitive disadvantage.

Monetary policy would now be dictated by the central bank of a foreign country, which means that interest rates could rise just when Scotland needs them lower, or fall when she needs them to increase.

At least initially, Scotland would be outside the European Union (EU). The blithe assumption that an independent Scotland could join the EU misses three critical points.

1. Joining the EU would take time, and the intervening uncertainty could be adverse for the financial services industry in Scotland.

2. Scottish membership could be vetoed, not least by a Spanish government mindful of the precedent which Scottish accession might offer to the advocates of independence for Catalonia.

3. New members of the EU are required to join the Euro, a monetary system which has inflicted painful internal devaluation on countries whose loss of relative competitiveness would otherwise have been remedied by conventional devaluation.

For the financial services industry, then, the loss of the UK sovereign guarantee would be compounded both by a competitive disadvantage and by monetary uncertainty.

This makes it highly likely that a huge proportion of the Scottish financial services industry would migrate, most obviously to London, which on most measures is the world's largest financial centre. Indeed, it has become clear already that RBS, Lloyds, Clydesdale and Standard Life are all drawing up contingency plans to move part of their operations to London in the event of a "yes" vote on independence.

The possible fiscal implications for an independent Scotland are set out in Figure 3, which assumes that half of the financial services industry migrates from Scotland in the first three years of independence. It also assumes that revenues from all other sectors increase at approximately the same rate as that assumed by H.M. Treasury for the UK budget. Taken together with the downwards trajectory in North Sea revenues, the implication is that the tax receipts of the Scottish government could fall markedly, This could be happening just as Scotland is trying to respond to the pressures for higher social spending which would undoubtedly be unleashed by the perception of freedom from the austerity agenda of the British government.

Additionally, of course, the fact of independence would itself impose extra costs as Scotland replicates many of the services hitherto provided on a UK-wide basis.

RISK #3: PUBLIC SECTOR PENSIONS

As anyone familiar with the issue knows, the system which pays pensions to public sector workers in the UK is a Ponzi scheme.

In the private sector, pension provision is "funded", which means that savers' contributions are invested to pay for those same contributors' own future pensions.

With some minor exceptions, however, UK public sector pensions are "unfunded", which means that no money is put aside to meet future obligations. Instead, current contributions are used to pay current pensions, and the workers of today will receive their pensions from the contributors of tomorrow.

Figure 3: Revenue projections, Scotland, 2012-13 to 2019-20 (£bn, current prices)

	Our forecasts					"Yes" forecasts*	
Year	Financial services	Other receipts	Receipts ex-N. Sea	North Sea**	Total receipts	Receipts ex-N. Sea	Total receipts
2012-13	£9.5	£38.1	£47.6	£5.5	£53.1		
2013-14e	£9.6	£38.4	£47.9	£4.5	£52.5		
2014-15f	**£7.2**	**£40.2**	**£47.4**	**£4.4**	**£51.7**		
2015-16f	**£5.4**	**£42.0**	**£47.4**	**£4.0**	**£51.5**		
2016-17f	**£4.0**	**£44.0**	**£48.1**	**£3.7**	**£51.8**	**£57.3**	**£64.2**
2017-18f	**£4.0**	**£46.1**	**£50.1**	**£3.4**	**£53.6**		
2018-19f	**£4.0**	**£48.3**	**£52.3**	**£3.1**	**£55.4**		
2019-20f	**£4.0**	**£50.5**	**£54.6**	**£2.9**	**£57.4**		

Sources: Office for National Statistics, GERS, *Outlook for Scotland's Public Finances and the Opportunities of Independence* and author estimates

* *Scotland's Public Finances and the Opportunities of Independence*

** Based on an assumed 90% share

Big problems arise, of course, where the sums being paid out to pensioners exceed the amounts being collected from current contributors. This is the situation that has now arisen, and even HM Treasury concedes that this is set to worsen – very rapidly.

The key numbers are set out in Figure 4. In fiscal year 2009-10, payments (of £24.4bn) exceeded contributions (£20.7bn) by £3.7bn. This gap, which has to be met out of general taxation, is already widening dramatically, from £4.6bn in 2010-11 to £6.7bn in 2011-12, £8.6bn in 2012-13 and £9.2bn in 2013-14, when contributions totalled £23bn whilst £32.2bn was paid out.

According to official projections, this gap will soar to £11bn in 2015-16, a number three times larger than it was just six years earlier. Based on current trends, the public sector pensions gap is set to widen to almost £18bn by 2019-20.

Scotland is particularly exposed to this trend because the public sector workforce is proportionately larger north of the border than it is in the rest of the United Kingdom.

The latest (March 2014) official figures show that, of 2.57 million workforce jobs in Scotland, 545,000 (21%) are accounted for by the public sector. In Britain as a whole, and excluding the financial sector jobs currently under state auspices, the public sector proportion is 17%, a number that applies also the rest of the UK. Put another way, public sector employment is 24% larger in Scotland (21.2% of the workforce) than it is in the rest of Britain (17.1%).

What this in turn means is that Scotland's share of public sector employment (10.2%) is larger than its pro-rata share of the economy (8.2%). Consequently, Scotland's share of the public sector pensions gap is set to rise from £0.9bn last year to a projected £1.8bn in 2019-20.

Of course, the UK position itself is not tenable on a longer-term basis, and Government will need to choose between one or more of three options, none of which is politically palatable:

1. Reducing pension payments, and/or raising the public sector pension qualifying age
2. Increasing the contributions of current public sector workers
3. Increasing the contribution from general taxation.

The particular problem for an independent Scotland would be that this issue is likely to arise sooner north of the border than it will in the rest of the UK.

Figure 4: Public sector pensions, 2009-10 to 2019-20 (£bn)

Year	Payments	Receipts	Net	Scotland
2009-10	£24.4	£20.7	-£3.7	-£0.4
2010-11	£26.0	£21.4	-£4.6	-£0.5
2011-12	£27.8	£21.1	-£6.7	-£0.7
2012-13	£30.6	£22.0	-£8.6	-£0.9
2013-14	£32.2	£23.0	-£9.2	-£0.9
2014-15f	£33.6	£24.0	-£9.6	-£1.0
2015-16f	£35.2	£24.2	-£11.0	-£1.1
2016-17f	£36.9	£24.4	-£12.5	-£1.3
2017-18f	£38.7	£24.5	-£14.2	-£1.4
2018-19f	£40.6	£24.7	-£15.9	-£1.6
2019-20f	£42.5	£24.9	-£17.6	-£1.8

* Sources: HM Treasury, Office for National Statistics and author estimates

RISKS – BETTER SHARED OR DIVIDED?

An analysis which highlights three critical risks would be incomplete if it failed to acknowledge continuation risk as well. The most serious of these is that the UK's current account imbalance is likely to continue to deteriorate, even if Scotland remains within the Union.

From £22.5bn in 2011, Britain's current account deficit widened to £59.7bn in 2012 and £72.8bn in 2013, the latter equivalent to more than 5% of GDP. The current account balance is broader than the balance of trade, and captures financial flows including returns on investment. The worsening in the current account reflects a deterioration in the net flows of dividends and interest between Britain and the rest of the world, as foreign ownership of British businesses has increased and British external indebtedness has expanded.

Essentially, there are two ways in which a shortfall in the current account can be met. Borrowing from overseas is one of these, and the sale of assets is the other. The limiting factor here is the UK's Net International Investment Position (NIIP). Official figures put this number at parity, but optimists (apparently including HM Treasury) believe that marking-to-market would improve this to perhaps 30% of GDP. Even this, of course, gives relatively little room to manoeuvre, when the annual current account outflow is more than 5% of GDP.

Were the UK to lose Scotland's North Sea oil flows, the current account imbalance would broaden from £73bn to over £100bn, the latter equivalent to more than 7% of GDP. This in turn would be well beyond the margin of sustainability, implying downwards pressure on Sterling and upwards pressure on interest rates.

Since, as we have seen, North Sea oil production is declining, this is a challenge that Britain is going to have to tackle anyway, certainly within no more than five years. However, the overnight loss of 90% of North Sea oil would be likely to narrow this scope for adjustment from five years down to zero years, crystallising a severe latent problem in the British economy.

Any Scot tempted into a sense of *schadenfreude* over the post-independence economic problems of the United Kingdom might do well to remember that the prosperity of an independent Scotland would be tied very heavily to that of Britain.

Thus seen, the case for economic and political reform within a united Britain seems compelling, particularly since all of the main British political parties accept the need to cede far greater powers to Scotland.

CONCLUSION

This report has concentrated on four economic risks, three of which are specific to Scotland whilst the fourth could be expected to affect an independent Scotland, too, by impairing the viability of her major trading partner.

Together, and as set out in Figure 1 above, the fiscal impact of independence in 2015-16 would be adverse for Scotland, as follows:

North Sea revenues: £2.9bn below "yes" case

Other revenue: £9.9bn below "yes case"

Public sector pension costs: £1.1bn adverse impact

Overall impact: £13.8bn below "yes" case

The projected revenue impact is huge, reducing anticipated tax income in 2015-16 by 22% when compared with the forecasts issued by the pro-independence campaign. And these effects could be expected to worsen in subsequent years, with North Sea revenues continuing to decline and the cost of unfunded public sector pensions continuing to escalate.

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