

Demographic Deficits and Fiscal Sustainability in Scotland

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There is a problem with the Institute of Fiscal Studies' (IFS) report on the Fiscal Sustainability of an Independent Scotland – but it is not one that the Yes campaign for Scottish Independence will welcome. The issue is a methodological one that is based on the way demographic projections are used to arrive at fiscal forecasts. The problem is that the demographic projections of the Office for National Statistics do not take account of the future economic changes in the Scottish economy that the IFS and almost all other economists predict. As a result, even in its best-case scenario for the future of Scottish independence, the IFS fiscal model may be overestimating the anticipated number of tax-paying workers in Scotland.

The IFS's demographic assumptions are fundamental for the construction of their fiscal model. The changing population size and structure, through variations in the birth, death, fertility and net migration rates, will have an impact on government revenues and expenditures. These changes will impact on the volume and structure of the tax take, as well as the spending on education, health, pensions and other services. The IFS says:

'The key drivers of changes in the fiscal balance in this model are changes in the demographic composition of the population, coupled with the underlying estimates of how the levels of certain types of spending and of certain taxes differ across different age–sex groups in the population'.

The conclusions of their report therefore depend on the demographic assumptions they have made. They go on to point out that 'other fiscal trends can also be incorporated into the model, such as the expected decline in revenues from the North Sea as reserves of oil and gas are depleted'. The focus here is on the fiscal impact of the *oil revenues* generated directly by North Sea activity. Because of the methodology used by the Office of National Statistics to produce demographic projections, however, the impact of this economic trend is not incorporated into their population projections and therefore into the demographic assumptions of the IFS model.

A closer look at the demographic assumptions of the model suggest that there are two problems for their fiscal forecasts: the first is that the IFS used 2010-based

projections that have already been superseded by emerging census information from 2011 (although it has to be recognised that this was the information that was available at the time they were carrying out their analysis); the second is that, because of the way demographic projections are calculated, they take no account of the predicted decline in North Sea oil activity.

It is widely recognised that the mid-year projections of the final year in an inter-census 10 year cycle are likely to be the least reliable of any mid-year data. It is the end process of ten years of partial surveys and estimates, before new reliable census information becomes available. Indeed, taking into account emerging census information that was not available to the IFS when it was creating its model, the annual long-term assumptions for net migration for Scotland have been reduced from 17,500 (2010-based projections) to 15,000 (2012-based projections). The latter figure was re-calculated on the anticipation of a new balance between increasing international in-migration and a much reduced flow of cross-border internal UK migration. [See the ONS Methodology paper of 6 November 2013.]

More important is the fact that demographers will normally make no allowance for uncertain economic change in their demographic projections. As they constantly point out, they deal with projections, not forecasts. Using International Passenger Survey and NHS baseline data for their 2010 migration projections, the ONS assume no change in the trends forecast for the decline of North Sea oil in the future. In their 2010 projections, for example, it is projected that the populations of Aberdeen and Aberdeenshire will grow at more than twice the rate of Scotland as a whole and the working-age populations of these areas at three times the Scottish average. Based on past experience of changes in age and gender cohorts and taking account of fertility, birth and death rates, these projections are a logical outcome of the demographer's endeavour. Given the IFS forecasts for the future of North Sea oil and what this will inevitably mean for net migration, however, their validity as the basis of a fiscal forecast must be questioned.

As North Sea oil activities decline, the net migration trends for Scotland in the next decade are unlikely to be the same as the last decade, irrespective of whether the government is located in Edinburgh or London. The principle assumption of the paper is that there will be net in-migration. The possibility of no change is also acknowledged and the Scottish Government's claim that a more liberal immigration policy than in the UK will also produce a higher number of tax-paying workers is tested. Given the projected decline in North Sea activity, it is surprising that a net out-migration scenario was not examined.

From 1951, through the 1970s and the 1980s and into the 1990s, net out-migration from Scotland was much higher than the natural increase and it is only in the last 12 years that that more people have been estimated to have been consistently coming into Scotland than leaving. Between 1971 and 1981, consistent with the decline in Scottish manufacturing, Glasgow lost 22% of its population and, although there was some migration to surrounding new towns, Strathclyde Region also lost large numbers, as did Scotland as a whole. With the decline of North Sea oil and all other things being equal, a decline of in-migration is inevitable and a return to net out-migration the most likely scenario.

Where the paper does investigate alternative assumptions about inward migration, it is mainly concerned with the Scottish Government's proposition that, with more liberal immigration policies, it will be higher than in the rest of the UK. Using the ONS 'high migration' projection, the IFS shows that the situation would be marginally better in 50 years time than under its principal assumption of low migration. Under the ONS 'natural change' scenario, the working age population would decline more rapidly and Scotland's public finances would deteriorate even faster. However, if Scotland reverts to the long-term historical pattern of net outward migration as work in the North Sea declines, the fiscal impact could be massive over the next 50 years.

If the numbers in the higher taxpaying ranges (men in the 35-65 age range) leave Scotland, the fiscal effect will be devastating and, in spite of the raising of the pension age, the out-migration of economically active individuals and families will

ensure an even higher dependency ratio in future. There are other things that could happen to change the fiscal impact of this, but current proposals are not realistic. A more liberal immigration policy, for example, will not work unless there are increasing employment opportunities.

In analysing the future impact of the decline in North Sea oil revenues in the UK, the Office for Budget Responsibility (OBR) has assumed that the UK Government will be able to find other ways to raise the same amount of money, such as raising VAT by 8%. The IFS has adopted this assumption in their analysis of the future fiscal position in Scotland. However, the impact of North Sea decline on Scotland is likely to be job losses in areas where the ONS at the moment predicts large increases in the population of income-tax paying workers and, as employment and taxes decline, so will consumption of goods that attract VAT. An 8% rise in VAT would be an additional incentive for Scottish workers, along with immigrants from an earlier era, to migrate across the border to more prosperous areas of the UK, such as the South East of England, as happened in the past.