CPPR Briefing Note
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CPPR
Centre for Public Policy for Regions

Reflections on the latest Oil and Gas related analysis by the Scottish Government and the Office for Budget Responsibility

Both the UK Office for Budget Responsibility (OBR) and the Scottish Government have recently issued new or updated information with regards to the North Sea's potential contribution to the economy and government finances (be it to the UK or to an independent Scotland).

Some of the key points made in the main papers, or in the briefing that accompanied these papers, need clarification in order to best understand their implications. The purpose of this brief note is to look at four issues in particular that have been given prominence in the recent coverage. In due course CPPR will produce a longer, more detailed, paper on some of the issues raised.

(i) Output per head in Scotland versus the UK and the perception of North Sea oil as a 'bonus'

An independent Scotland's output per head would be of a similar size to that seen for the UK as a whole and higher than that of the UK if North Sea activity was added. However, such a statement does not fully explain Scotland's underlying economic and fiscal strength or weakness.

First, and as fully explained in an earlier CPPR Briefing Note[1], due to the large degree of overseas ownership with regards to North Sea (and other) activity, Gross National Product (GNP) is the more appropriate measure for Scottish economic output than Gross Domestic Product (GDP)[2], which exaggerates Scottish prosperity.

Second, while Scotland's onshore economic activity per head of population is comparable to the UK's, the tax revenues arising from on-shore activity would not be sufficient to match the current Scottish government spending, even allowing for the existing degree of borrowing implicit in the UK's fiscal deficit. This is not because of low Scottish revenues (excluding North Sea oil) but because government spending per head in Scotland is well above the UK average.

As a result, the Scottish Government would need to rely on most, or all, of the tax revenues from the North Sea simply to attain the current, implicit, level of annual fiscal deficit. This would mean that no such revenues would be available to build up a Sovereign (Oil) Fund, or at least not without tax increases or budget cuts.

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[1] See CPPR Briefing Note 'Measuring an independent Scotland's economic performance', available from the website at - www.gla.ac.uk/schools/socialpolitical/cppr - under current publications.

[2] GNP relates to the economic income that is retained within a country, whether from domestic or overseas activity, while GDP relates to what economic income is produced within a country, regardless of whether it stays there or is ultimately remitted overseas.

For this reason it is important to differentiate between the output per head of an independent Scotland and what level of public spending that output would allow for, based on current rates of taxation.

Hence, while Scotland would not be an “oil based economy”, it would, initially at least, be heavily reliant on the taxes from the oil based part of its economy in order to fund current levels of government spending.

(ii) The profile of future North Sea production and tax revenues

Recent years, 2011 and 2012 in particular, have seen much larger reductions in North Sea output than forecasters expected.

There is now much divergence of opinion amongst such forecasters over whether there will be a degree of bounce back (e.g. Oil & Gas UK) from these falls or just a levelling off for a few years at current output levels (e.g. OBR). Much of the current divergence in various production forecasts is based on the degree to which traditionally bullish industry forecasts are reduced by applying negative contingencies.

At this stage it is impossible to know what the answer will be. However, in considering the future it is worth bearing in mind certain long term trends.

As the Scottish Government release suggests, successive UK governments, as well as independent forecasters, have repeatedly underestimated the long term life of the North Sea in continuing to be economically viable.

However, such pessimism does not apply to medium term forecasts of North Sea oil and gas production. Here the bias is the other way round with repeated over-predictions of oil and gas production levels. For example, OBR, using DECC’s oil production predictions, have been overly optimistic in every set of projections made since its inception. Oil & Gas UK have been similarly over optimistic since at least 2008. Any idea that UK government departments (and implicitly the independent OBR) may be serially under-estimating future oil production levels seem odd when juxtaposed with this evidence of repeated over-prediction of production by DECC and OBR in recent years.

In their latest long term ‘Fiscal sustainability report’ on the UK, OBR included high and low price and production scenario variants up to 2040-41. Even using the high variants for both price and production, at no point do North Sea UK tax receipts return to their current (2012-13) level. On the other hand they could still be worth up to a substantial £4½ billion by 2040-41 based on the high price and production variants (or around £2 billion using the central projections for price and production levels).

Equally, the figures projected by Oil & Gas UK are unlikely to result in tax revenues returning to even the levels seen in recent years unless prices also rise. Such a high oil price scenario could also result in offsetting, negative, effects on Scotland’s non-oil sectors.

While only time will tell what the final outcome will be, from a budgetary position it seems sensible to use a cautious projection for tax revenues, with any "out-performance" being used either as part of a 'stabilisation fund' or to lower Scotland's level of borrowing[3].

(iii) The dependence of Scotland on oil versus other major oil producing countries, e.g. Norway

An independent Scotland would have a lower share of its GDP reliant on oil and gas than Norway currently has. What is more, in terms of GNP, this reliance would be even lower as more of Scotland's North Sea activity is foreign owned compared to Norway.

However, this fact is largely irrelevant as Norway's higher reliance simply equates to the larger oil and gas resource available to it, which would normally be viewed as a good thing.

Of more relevance is the fact that the government of an independent Scotland would be more reliant than Norway on using tax revenues from the North Sea to balance its budget. This is because the Norwegian government puts most of its North Sea revenues into a Sovereign Fund and, typically, uses only the annual interest from this fund to support annual spending commitments.

In contrast, and as discussed above, at present (2012-13) levels of expected UK North Sea tax revenues, Scotland would need to use all such funds just to compensate for the loss in (higher) spend per head on public services as a result of leaving the UK.

(iv) The establishing of an Oil Fund

While the establishment of such a fund would be welcome, the Scottish Government paper makes the point that this would happen "when the fiscal conditions allow". However, the paper takes us no further forward in terms of understanding what that actually means.

As discussed above, at present all such oil revenues would be needed to help pay for existing public service levels, while still running a considerable annual fiscal deficit, with none left over for such a fund.

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[3] Further discussion of key North Sea oil and gas issues is contained in the CPPR paper 'Analysis of Scotland's past and future position – Reflections on GERS 2014, the Scottish Government's Oil and Gas Bulletin and the 2013 UK Budget', also available on CPPR's website.