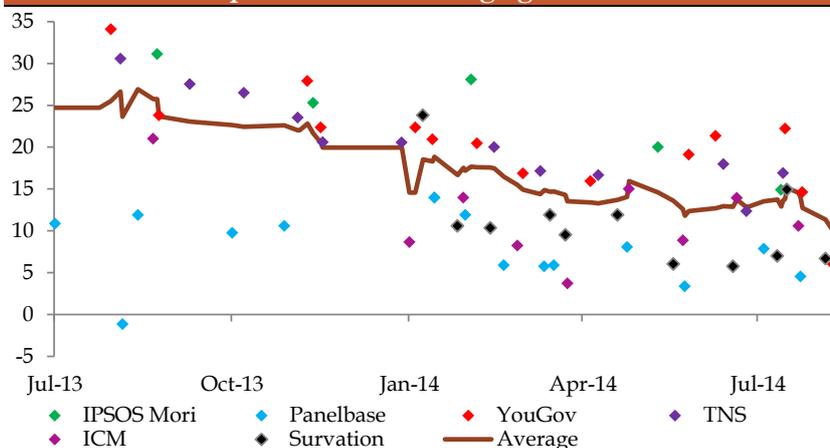


Should auld acquaintance be forgot?

- **Tightening polls raise the risk of Scottish independence.** The majority against independence fell to six points in the latest YouGov poll, down from 22 points in early August. That follows Scottish National Party leader Alex Salmond's win in a 25 August televised debate with Alistair Darling, head of the anti-independence campaign.
- **We expect Scotland to vote no to independence on 18 September.** The anti-independence camp leads and polls do not always translate into results. The final poll before Quebec's 1995 independence referendum showed 53% in favour of independence, yet the final result was 50.6% against. Admittedly that was very close, but voters may find it harder to support change in the polling booth.
- **Still, the latest YouGov poll is important.** Because YouGov usually finds a larger majority against independence than other pollsters, the recent result suggests other polls could soon record a majority for independence. As we argued in our note [UK risks: politics is top of our list](#) (21 July), the risk that Scotland will vote for independence is real.
- **A yes vote could cause serious short-term pain.** Some financial firms may move south and uncertainty about currency arrangements and the status of Scotland in the EU would surge. Long term, Scotland would be forced into austerity. For the rest of the UK, losing relatively pro-EU Scotland would raise the risk of Brexit from the EU.
- **A deal would be reached.** We expect that London and Edinburgh would reach a deal on the outlines of a velvet divorce quickly in the event of a yes vote. A long, noisy negotiation would drag out uncertainty and the short-term pain, which would suit no one.
- **A no vote matters too.** A close vote would keep alive the chances of a second referendum in 5-10 years, so uncertainty would remain. A no vote would mean more devolution, with additional powers for Scotland probably kick-starting changes to UK regional governance.
- **In the long run, policies matter.** In principle, Scotland can function well alone or as part of the UK. It may use independence or devolution to pursue more growth-friendly policies. But if it uses any of its extra powers to pursue policies that scare businesses away, it will be worse off.

Chart 1: Anti-independence lead falling again



No lead, excluding don't know responses. Each diamond shows an individual poll result. The line shows the average of the last available observation from each of the six polls. Source: UK Polling Report.

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Polls are likely to tighten further

The eerie quiet ahead of Scotland's 18 September referendum on whether to leave the UK was broken this week. A 1 September YouGov poll showed a sharp fall in the anti-independence camp's lead, taking it down to six points from a huge 22 point advantage in early August. It is a timely reminder that, as we have cautioned before (see, for instance, [UK risks: politics is top of our list](#) dated 21 July), the Scottish referendum result is particularly difficult to call and the possibility of a tight vote should not be dismissed.

Support for Scottish independence has risen

Importantly, the YouGov poll is one of only two taken after a 25 August televised debate between the pro- and anti-independence camps. That suggests the narrowing is not just a statistical aberration. Moreover, among the competing polls, YouGov has tended to show some of the largest leads for the anti-independence camp. If it shows the race as tight as it has done, other polls more favourable to independence could well show a majority in favour of independence in the coming days. There will be more events to rattle markets then.

Some polls could show a majority in favour of independence in the coming weeks

We still expect Scotland to decide against independence. The no camp still leads even though the polls have tightened. Indeed, we had expected the polls to narrow considerably in the final few months of the campaign. Nevertheless, the probability of a yes vote has risen. At the least, the final outcome is more uncertain now.

We still expect a vote against independence

The wide spread of polls (see Chart 1) is one reason why the final outcome is especially uncertain. Ahead of the actual vote, it is impossible to know which most accurately reflect sentiment. We suspect the polls recording a wider no lead are asking a more appropriate question – how would you vote if a referendum were held tomorrow? But there are many other factors that could trump that as an explanation for poll differences. For instance, 16-17 year olds can vote in the referendum, but they will be hard to weight accurately given their lack of participation in previous elections.

But there is a lot of uncertainty. Polls are widely spread

As well as the wide range of polls to pick from, there is the question of whether voters' poll responses will translate into actual votes. Ahead of Quebec's 1995 referendum on independence from Canada, for instance, polls showed a majority in favour of independence yet the final result was 50.6% against. It may be easier to contemplate secession when talking to a pollster than when in the polling booth.

Moreover, polling may be unreliable

The short-term economic risks are, of course, much greater from a yes than from a no vote. But it is worth remembering that either outcome would bring big changes to the UK. A no vote would certainly not come without costs.

A yes vote would cause greater short-run pain. But either outcome would mean big changes

What would happen after a yes vote

We covered this possibility at length in our 21 May note [Narrowing Scottish polls raise UK political risks](#). In short, the near-term fallout could be serious. The biggest initial issue would be a spike in uncertainty. Firms could delay investment and consumers could shun big-ticket spending until the post-independence arrangements became clear. That could cause a serious setback for the Scottish economy and a material hit to the “rump UK” (RUK). It is impossible to estimate the precise impact. But the recent experience of

The near-term fall out of a yes vote would be serious

elevated uncertainty during the euro-crisis suggests a material effect.

In addition to that immediate rise in uncertainty, there would be other serious issues. The government's financial position means there would probably need to be significant further austerity. Government borrowing costs would be higher and there would probably be economic disruption from a new Scottish currency. There would be the tail risk of some capital outflows. Scotland would be able to maintain EU membership, but not necessarily on the same terms as the UK has now. Scotland might need to agree to join the euro, although that would have few immediate practical implications.

Uncertainty would spike

Some of Scotland's financial-sector companies could shift their headquarters to London or elsewhere given the likely economic disruption; that might significantly hit the economy. Overall, we judge that the few years following the vote would be tough albeit not calamitous. Indeed, in our view a key point in judging the likely degree of fallout from an independence vote is that it would not be sensible for UK politicians to undermine the Scottish economy. That should limit the downsides.

The few years following the vote would be tough though not calamitous

Indeed, in the event of a yes vote for independence we expect a velvet divorce – a quick deal that splits assets and liabilities along geographical and GDP-based criteria where relevant (eg oil geographically, debt by relative GDPs). The technical challenge of splitting two advanced countries would take a long time to work out, but an outline political deal that markedly eased uncertainty could be reached relatively quickly.

We expect a velvet divorce

Politicians on both sides of the border would have an incentive to rapidly agree an amicable divorce. Ahead of the May 2015 general election, the Westminster parties would certainly have little interest in precipitating a new economic crisis. That would obviously be bad for the RUK economy in the short term, but could also severely damage relations between the two countries which would, after all, still be sharing a border and plenty of infrastructure. In the event of a yes vote we expect that, having got his big prize, Alex Salmond would be pragmatic. The incentives to agree a deal would probably be stronger for the government north of the border, whose economy would be the epicentre of any downturn.

Politicians on both sides of the border would have strong incentives to agree terms quickly

The question about the post-vote deal, splitting assets and liabilities, currencies and so on, is not the most interesting. Whatever the split, there would likely be a few difficult years for Scotland. The key to the longer-term outlook for Scotland is how policies would change following a yes or no vote. Would the Scottish government pursue better or worse economic policies? There are risks on either side.

The key to the longer-term outlook is how policies would change after the vote.

A yes vote could lead to a leftward tilt in Scotland and policies that harm long-term growth prospects. On the other hand, a Scotland that would reap all the benefits as well as all the costs of its actions would have the incentives to pursue growth-enhancing policies. Leaders do not always take the route of worthwhile reforms immediately, partially because they can be painful. Think of Francois Hollande or Gerhard Schroder. Ireland did not perform well economically until a long time after independence from the UK in 1922. But many governments get there eventually. Indeed, policies both north and south of the border could tilt right. The long term could be positive

Scotland could tilt left or implement growth-enhancing policies

economically for an independent Scotland.

There are also risks to the RUK from a yes vote. The rest of the UK, shorn of Scottish support for the EU, could vote itself out of the EU single market. Indeed, that could be one of the long-term risks for the UK.

If Scotland votes yes, the risks of Brexit would rise

A no vote would also bring significant, though more slow-burn, changes

More detail on our view is available in our 21 July note, [UK risks: politics is top of our list](#). In short, the first result of a no vote would be residual uncertainty. Only a large majority against independence, which is unlikely now, would put the issue to bed. As was the case after Quebec's 1980 independence referendum, nationalists would probably push for a second vote, dragging out uncertainty over Scotland's place in the UK. Uncertainty could have driven some of Quebec's relative decline between the 1980 and 1995 referenda.

There would be residual uncertainty after a no vote, which could have meaningful consequences

The second result would be widespread devolution. All parties have committed to considering further devolution of government powers to Scotland. Whether the referendum results in a yes or no, a large chunk of the Scottish electorate is demanding more say in government policies.

There would also be widespread devolution.

Scotland does not operate in a vacuum. Further devolution of powers to Scotland would worsen the already chaotic British constitutional arrangements. The Welsh Assembly, for instance, may seek more powers. The "West Lothian" question would be even starker: Scottish members of the Westminster parliament can vote on policies that affect only England while English members cannot vote on some policies that affect Scotland. There is no major popular pressure to resolve this question, which is an issue more among the political elite than the public. Nevertheless, Scottish devolution could prompt wider changes to British governance.

Scottish devolution could prompt a shake-up of governance elsewhere in the UK

The benefits of devolution would depend on how well any new powers were exercised. If the Scottish parliament were responsible for a larger proportion of tax revenues, that could sharpen its incentives to set growth-enhancing policies. Even so, countries and regions can have good and bad governments even when they have tax-raising powers. The most that can be said about the likely outcome of further devolution is that Scottish voters would have more opportunity to choose national policies.

The benefits of devolution would depend on how well any new powers were exercised

At present, power and policy are centralised in the UK. Regions and cities have little independent power. Some of the most economically successful countries in the world have more decentralised powers than the UK eg the US, Switzerland and Germany. The US in particular offers the potential for widely different policies between states. There could, in our view, be big benefits from cleaning up the somewhat chaotic UK system of government and devolving responsibilities to countries, regions and cities.

Power and policy are centralised in the UK

That being said, these are slow-burn issues. Agreeing further devolution could take several years. Politicians may take even longer to begin to flex their new-found powers. Scotland has had the ability to change income tax rates by 3p up or down since 1998 but has never used it. The UK will fundamentally change in the next few years but it may not affect the macro-economy much in the short run. The most significant aspects of devolution for businesses could be through the policies adopted by governments. They are hard to anticipate, as it will depend on which parties are in power.

These are, however, slow-burn issues

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