SELECT COMMITTEE ON ECONOMIC AFFAIRS

The Economic Implications for the United Kingdom of Scottish Independence

Oral and Written Evidence

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TUESDAY 20 NOVEMBER 2012

Members present

Lord MacGregor of Pulham Market (The Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Baroness Kingsmill
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord Rowe-Beddoe
Lord Shipley
Lord Skidelsky
Lord Smith of Clifton
Lord Tugendhat

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Examination of Witnesses

Mr Rupert Soames, Chief Executive, Aggreko plc

Q794 The Chairman: Welcome, Mr Soames, to the Economic Affairs Committee. This is the 16th public hearing of the inquiry into the economic implications for the United Kingdom of Scottish independence. It is generally the feeling of this Committee that we very much wanted to hear from as many witnesses as we could from the business community about the implications of Scottish independence for them. It has not always been easy to get them, which is why we are particularly grateful to you for coming this afternoon. You are very welcome, not least because Aggreko is now a major international company—listed on the FTSE 100—which is all over the word but has its base and headquarters in Scotland. So it is very helpful to have your perspective. Would you like to make an opening statement or do you want to go straight to questions?

Mr Rupert Soames: May I just say a few things to give a taste for those who do not know Aggreko—not about what we do but the shape of the business. We employ about 6,500 people worldwide and about 10% of those are in Scotland. We have our headquarters in

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Scotland and we do all our worldwide manufacturing from a new factory that we have just built near Dumbarton. So Scotland is the heart and soul of a lot of our operations and very important to us. To give you a sense of the rhythm of how being headquartered in Scotland works for an international company, the reality is that my CFO and I spend about 15% of our time in Glasgow, probably double that or more in London and the rest travelling to far-off lands, drumming up business. That gives a sense of the weight of our operation. One percent of our revenue comes from Scotland and 5% from the UK as a whole. I think that is the pattern of a lot of the larger companies in Scotland; they have their home and heart in Scotland but all the business is done outside.

Q795 The Chairman: That is very helpful because it leads into my first question. Given that you are a Scottish-based, multinational company, as you have very clearly described it, what do you see as the main commercial, financial and economic implications for companies such as yours if Scotland were to become independent? Does that lead you to have any different perspectives from, say, a purely Scottish-based manufacturer without the same worldwide implications as you have?

Mr Rupert Soames: To preface my view on this—I speak for myself—I noted in some of your earlier evidence a certain frustration with the pusillanimity and unwillingness of businesspeople to come and have their names be counted on this issue. I think there are a couple of explanations for that. One is entirely praiseworthy, and that is a natural reluctance and distaste for large and rich companies throwing their weight and money around in support of highly contentious political issues. Within Aggreko itself, there will be people with a wide range of views. There is a natural reluctance and that is probably for the good. To paraphrase Bacon, one has to say that much-speaking businessmen are like ill-tuned cymbals. There is a second reason why there is a certain unwillingness to speak: over the past couple of years, anyone who has dared open their mouths on the subject with views that are contrary to those of the SNP have brought down on themselves rains of bile and ire, which is really very unpleasant. A lot of the language is very intemperate. I bluntly think that people think they have better things to do than be hauled over the coals. I think that process will begin to change as we get closer to the referendum but there is no doubt that people have been unwilling to speak out.

As far as Aggreko is concerned, I can say very simply that my view of what the impact of independence on our business would be is that the advantages would be small, tenuous and unlikely to arise, and the disadvantages could be large, serious and very likely to arise. It would, in the short term, undoubtedly produce a great deal of business disruption. We run a business that has revenue of getting on for £2 billion and 6,500 employees. We have a head office of 35 people, including the janitors. We run a very full ship. We would have to commit significant resources to managing whatever came out of separation. To give an adage, I never had a friend come along to me and say that their divorce ended up being much easier than they thought it would be when they set about it. It would be a matter of enormous short-term complexity. But at the end of the day, this is not an issue that is dominated only by the short term. It would real bore, it would be a diversion and it would mean that we could not do other things. It would mean that we had to concentrate on managing whatever arose around currency and tax.

Secondly, it would put in a permanent layer of additional complexity to have our head office and manufacturing in one country and our listing in another, with all the splits of people going backwards and forwards. I think that would be a problem.
Thirdly, I would be quite nervous about having a large chunk of our operations based in an economy that would be so hugely dependent on hydrocarbons. Some of the evidence that you have previously taken says that it is not only the absolute level of income but the fact that it could be very volatile. In the lovely 1920s phrase, it would be quite nervous-making to be sitting there with a Government that very properly has high ambitions for the quality of its public services. As other evidence that you have taken has shown, the fiscal position would be challenging at the very least. I would be made nervous if the Government’s budget was dependent to that extent on hydrocarbons. So, broadly speaking, for our business, Scottish independence would be unlikely to be a positive move.

Q796 Lord Tugendhat: Mr Soames, if Scotland becomes independent, which currency would you expect it to use? At one time it was SNP policy that Scotland would join the euro. Now, as far as we can gather, the preference is to stay in sterling, but even staying in sterling is not a simple business. As we have seen in the eurozone issues, you would need understandings of a fiscal, banking and monetary nature that would inhibit what might be thought to be total independence.

Mr Rupert Soames: I think this is wrapped up with the tax issue. Quite a lot of the promise of independence lies around the idea that we can have a different tax regime north of the border. This seems highly unlikely, either in the context of being part of the euro or having monetary policy effectively controlled by the MPC in London. In either case, there will have to be a Maastricht with straps on. We have already discovered that Maastricht was not tight enough in its rules around deficits and the like to be able to avoid some sort of disaster with the currency. I have enormous doubts about whether the EU would welcome another state joining the euro, particularly one with the fiscal position that Scotland standing alone would have, so I think that it would probably have to be sterling. I just think that what you will get is a very rigid structure applied to the Scottish economy and fiscal position, which will make the whole thing fairly pointless because they will not be able to change the tax rate very much within that structure.

I would also say that as far as the corporate tax rate is concerned, I suspect that Ireland somehow cornered the market. Those people who wanted to go to a low-corporate-tax environment have already gone to Ireland. What are they going to do? Are they going to move to Scotland? The fact is that the opportunity to have a low corporate tax rate within the EU and within the eurozone has gone. Ireland has been providing it now for many years. It has taken a certain amount of benefit from it but not a huge amount; the low tax rate has certainly not done great things for its fiscal position. Anyway, the UK corporate tax rate is down at 22%, so the idea that you could somehow create a low-tax zone is wrong. I do not think it much matters whether it is the euro or the pound; either way, anyone who takes on the lender of last resort responsibility will insist on some very tight rules, which will be extremely hard to apply when you have an oil price that might go from $40 a barrel up to $160.

Q797 Lord Smith of Clifton: You have really answered the question that I was going to ask you so I will go on to question four, if I may. Do you expect an independent Scotland to introduce corporation and personal tax rates that are different from those for the rest of the UK, and how might Aggreko’s business be affected? How important a consideration is the level of corporation tax as firms decide where to invest, or even whether to relocate their tax domicile? You have already said that Ireland has taken the opportunity.
Mr Rupert Soames: And we did not move to Ireland. Some companies can easily move their domicile and others cannot. To give you an idea, in 2011 we paid £86 million of corporation tax, which was at a rate of about 24% or 25%. Thirty per cent of that went to HMRC and the rest was paid overseas. One per cent of our revenue is in Scotland. How much tax, pray, are we going to be paying in Scotland? It is mostly done overseas.

One of the big impacts and complications for us as a global business will be around double taxation agreements. The people who will have a ball with independence are all the professional advisers—all the accountants and lawyers. It will magnificent for them, but for us hewers of wood and drawers of water it is going to be a nightmare. I think it will be very difficult to implement and real issues will come up about where costs fall and transfer pricing between the two. As I said, divorce is a whole lot harder than marriage. Splitting these out in a way that is equitable will be very testing. The scope to provide major corporation tax differences or personal taxation differences will be very small because of the economic circumstances.

The other thing is to do with the risk of the tax rate changing. If it comes down, the risk of it having to go back up again will quite discourage people moving there in the first place. It is quite difficult for us as a global company to persuade people to come and work for us in Glasgow because of the whole infrastructure. If you go on to the web to look at international schools where children can be educated to baccalaureate standard, there are hundreds of them in England but I think there is barely one in Scotland. People say, “I’d love to come but where will my children go to school?” If you layered on top of that a whole lot of tax complexity, it would be even more difficult.

Baroness Kingsmill: Mr Soames, in the interests of full disclosure and on the advice of the Clerk, I am informing you that I am the SID for APR Energy, a mere minnow in relation to you but nevertheless—

Mr Rupert Soames: A distinguished part of our competitive environment.

Q798 Baroness Kingsmill: Indeed. Is it your view that Scottish voters, and business leaders in particular, have enough information about the implications arising from independence? If they do not, which would be surprising in some senses because of the amount of newspaper coverage—maybe that has not been particularly informative—what sort of information do you think should be out there? What kind of information would be useful? I suppose we are asking you to say something along the lines of, “This report would be extremely useful”.

Mr Rupert Soames: You do not even have to lead the witness on this one, Lady Kingsmill. The witness is already galloping along the path and you are having to restrain him. I read some of the evidence that this Committee has taken. I truly say that it is the first place where I have seen all the different strands pulled together in one place by some very interesting experts. Whoever has brought the witnesses together has done a jolly good job because you have a lot of different areas covered. I do not know of anywhere else that has happened. I do not know where in the public fora this has happened.

I also note that the Committee’s deliberations, while published on the web, have hardly been covered at all in the Scottish press, which is sad. Consider the process that happened around the euro, which was arguably less important than this but certainly a very important issue. God bless the Chancellor. There were the five economic tests—or was it seven?—and reams of paperwork were produced by the Treasury. I think we are promised some of these
by the Treasury but the fact is that a lot of the people involved in this debate do not have access to solid data. The debate has been curiously ill-informed.

Having said that, it is important to recognise that part of the problem is that a lot of this debate is not about economics, although the polls say that if it were to cost the average Scottish voter more than £500 a year they would definitely say no. I do not think it will be a difficult sum to do.

Q799 Baroness Kingsmill: What other information would it be useful to provide?

Mr Rupert Soames: It would be helpful and important for the debate if the two sides of the argument were able to settle on what the currency would be. Because once England and Wales say, “Yes you can be part of the sterling area”, and have, if not the complete negotiation, I think it would be a mistake for London to say, “We are not going to tell you what it is going to be”. I think that is a real mistake. One has to take this process seriously. The people of Scotland are going to have a referendum. It is a very important choice and London needs to start engaging in the conversation about what it might look like. People can then reach some sort of informed opinion about it. Likewise, with the EU, the First Minister should be engaging with it and saying, “What about the euro?”.

Q800 The Chairman: Does that mean that if it is sterling, for example, that all the issues of lender of last resort ought to be made plainer before the referendum takes place?

Mr Rupert Soames: They would be because then there can be a discussion about it. There is an element of saying that if you leave it all up in the air, people will get frit because of all the uncertainty. That does not treat the question with the seriousness that it deserves. A substantial and valued part of the United Kingdom is to be given the opportunity to secede. It is utterly wrong if London turns around and says, “You go and have your little referendum and we’ll tell you how it’s going to be organised afterwards”. There has to be some engagement, some working parties set up, for the sake of democracy—so that people can make informed decisions.

Q801 Baroness Kingsmill: Also, you refer to the climate of fear. Nothing dispels a climate of fear quite like information.

Mr Rupert Soames: I completely agree. The more this gets debated, the better. The answer may come back from the Scottish people, “Yes, we want to do this”. In that case, the fact that some preparation has been done in advance may make it less traumatic. This is potentially going to be traumatic for England as well as for Scotland. We have to take this process seriously and maturely and we have to enable people to get a taste of what choice they are being offered.

Q802 Lord Forsyth of Drumlean: Mr Soames, I hope that you will not mind my asking you to clarify something that is not directly related to the inquiry. You appeared to suggest that Scotland did not have outstanding state or independent schools of international standard, which I am sure you did not mean to imply.

Mr Rupert Soames: Can I just correct that? What I meant was someone coming in from the American system, for example. A lot of expats educate their children to the American system or to some other system. These are freely available. You can go to the Lycée if you want the French system or you can go to endless US schools. Although the Scottish system is admirable, first class and everything positive one can say about it, you go and try to get an
education for the Americans. The problem is for people coming in. The system is also very rigid and not easy to bring 12 or 13 year-olds into.

**Lord Forsyth of Drumlean:** I entirely take the point. Indeed, 20 years ago, when I was Education Minister, I tried to bring in the baccalaureate system for that reason. I thought that we should just get that cleared, in case it was misinterpreted.

**Mr Rupert Soames:** Thank you for very helpfully not letting me fall into a very large hole. I encourage you to warn me of any other holes that you see me marching into.

**Q803** **Lord Forsyth of Drumlean:** I have a question related to our inquiry, which follows on from the Lord Chairman’s point about lender of last resort. You implied that there would have to be some kind of negotiation, which I certainly agree with, but could you just explain to me why the English taxpayer would want to stand behind what would become a foreign country, in terms of the Bank of England being lender of last resort at all?

**Mr Rupert Soames:** That is a good question. I do not know. Ultimately it would have to, in the same way as the British taxpayer had to offer succour and aid to the Irish Government. It is about when your neighbour really gets into trouble. We are all part of the same country, but I do not know how we would justify it. Presumably, it would be some part of also saying that you needed something in return for that. We have all sorts of close relationships with Scotland—we have the hydrocarbons and this, that and the other—and there would have to be an untangling. It strikes me that it is quite difficult to go to any group of people and say, “Would you mind taking on the role of lender of last resort without something coming back the other way?”

**Q804** **Lord Forsyth of Drumlean:** We obviously have two years until the referendum, but given that this would be part of some kind of negotiation, as you say, what impact do you think this long period of uncertainty is really having on the ground, in terms of investment and other decisions that you and your colleagues are taking?

**Mr Rupert Soames:** I expect not great at the moment. It did not stop us investing £20 million and building a new factory in Scotland. This sort of thing can be overstated. Maybe it is because the bookies have it right when they say that it probably will not happen. If people began to believe that the vote for independence would go the other way, I think that that would cause delay and so on. A lot of people are carrying on with their lives without trying to second-guess this. I know that Diageo have invested £1 billion in whisky. Their position is that they cannot get whisky from anywhere else, so I am not sure what choice they have. We all have to get on with our lives. I think that if it got closer down to the wire, you might see stuff getting deferred. What I know is that, if it actually happened, it would then be extremely disruptive having to go through all the issues around tax, currency and everything like that.

**Q805** **Lord Hollick:** Mr Soames, you have led a company that has grown impressively over the past decade. To what extent have you benefited from being placed in Scotland and to what extent have you benefited from Scotland being part of the European Union? One of the controversial issues that has arisen recently is the ease with which Scotland, were it to become independent, would be able to join the European Union and, if so, on what terms.

**Mr Rupert Soames:** Being part of the European Union would be the sine qua non of our having our headquarters and manufacturing facilities there. We need not only access to the free passage of goods within the EU but the protection of all the EU trade agreements, which mean, for instance, that we can send our fleet into Mexico duty free because there is
an EU-Mexico treaty. Energetic though the Scottish Government may be, I am not sure whether they will have the ability to replicate all the EU treaties, although I have to say, for the record, that the same would apply to the UK. As a business, we have to have the protection of the EU trading agreements not only inside Europe but as they affect other countries, if we are manufacturing here and exporting round the world.

As for the first part of your question—how much has being Scottish-based made a difference to our business—I would say quite a lot. Culture is a really important part of our business. We think that what has enabled us to grow as fast as we can and to have what little success we have had are the dedication and entrepreneurialism of the people, in particular our ability to access this fantastically effective diaspora. People talk about the Jewish diaspora, but it has nothing compared to the Scottish diaspora. We are able to turn up in Yemen and have a Burns Night supper in the middle of San’a—people in kilts appear from all sorts of directions. One of the issues for Scotland is that so many of the most able people have sought their living around the world. We find them and they work for us, but they work for us in Manila, Buenos Aires, Mexico and Afghanistan—everywhere. Burns Night is an important moment in every Aggreko calendar and the place goes wild. Culturally, that has been an important issue. The fact is that we are able to find in Scotland businesspeople who are well suited to our business—people who are hard-working, intelligent, diligent, entrepreneurial, adventurous and with a world view. That has done well for us. I have to say that having our headquarters 500 miles away from where we are listed is not a plus. We had the choice of moving our manufacturing away from Scotland two or three years ago and we made a careful and deliberate choice to move it from Dumbarton to Dumbarton—to move it two miles up the road and build a bigger shed.

Q806 Baroness Kingsmill: I can understand that you would not want to move because of all the inconvenience, but given the international nature of your business, in practice you could be almost anywhere. You could reproduce those elements that you have talked about elsewhere. I appreciate your loyalty to Scotland, but what would independence have to do that would make you want to move and thereby overcome the status quo?

Mr Rupert Soames: We have to take that one step at a time, but we are rational economic animals. We also, as a business, are obsessed with keeping things simple and doing them well. We like to have a few good people rather than herds of ordinary ones, and that is why we have a few good people in Scotland running the business. It will depend on whether we can keep good people there. The tax rate is clearly going to have an effect on that because you can hop over the border and have your headquarters in Carlisle. In the rush hour it does not take much longer to get from Carlisle to Dumbarton than it does from Sauchiehall Street to Dumbarton. I would not want to speculate on that, but I think that you should not underestimate the desire to avoid complexity. If corporation tax was so important, why did we not move to Ireland? The answer is that because it would have been too complex and difficult. It was just not on. However, if we are faced with a situation where there is a huge burden of additional complexity in the long term— I am utterly certain that we will have a huge burden of extra complexity in the short term; that is unavoidable—it would be very likely. The other thing is that our investors are going to have something to say about this. A lot of our investment funds have quite targeted investments in the FTSE, and I know that the FTSE is very much focused overseas, but what will increasingly be thought of as being slightly eccentric is that, granted that a large number of your investors are in London, why do you want to come up here? I claim to be the only person that EasyJet greets by name at Luton airport.

Baroness Kingsmill: I am disappointed to hear that.
Mr Rupert Soames: We are up and down the whole time. People ask us why we do it. We would have to take it as we see it. In the end it is not only the headquarters, it is also whether we would move our factory. That is profoundly unlikely. You would have to provoke us pretty hard for us to move the factory, but funnily enough the EU would provoke us. Non-membership of the EU would do that.

Q807 Baroness Kingsmill: That is what I was getting at. What would it take?

Mr Rupert Soames: That would have us off in a flash.

Q808 Lord Levene of Portsoken: Taking you up on that point and being slightly provocative. Should we infer from what you have said that if an independent Scotland remained part of the EU, and the UK outwith Scotland decided to leave the EU, would that make you take the decision to remain in Scotland and not be part of the UK?

Mr Rupert Soames: There is a thought. Without wishing to go into the EU debate, I would make just one point. It is commonly thought that the EU benefit comes from trade within the EU. We see the world as a two-speed place. There is a world that is growing at 1.5% a year and there is a world that is growing at around 4.5% a year. Europe and North America may get to 3% on a good day, but there is a whole world out there that is growing at between 4% and 5% a year, and that is where we get most of our growth from. We need to be within a structure in which there are people with big boots and big heft who are able to cut the trade deals that we need to sit under the umbrella of when we are dealing with other countries. The idea of all that being a series of bilateral deals would be profoundly unattractive to us.

Lord Shipley: You said earlier that the problems caused by independence would be large, serious and likely to arise.

Mr Rupert Soames: For our company.

Q809 Lord Shipley: Indeed, for your company. Could you widen the scope and talk about the economic structures of Scotland and the rest of the UK. In what way do you think they are similar and in what way do you think they may be dissimilar? If Scotland were to become independent, how would you expect those structures to change over time?

Mr Rupert Soames: There is a pay grade issue here, which is that that question sounds above my pay grade. I really do not know. It is part of the issue I was talking about earlier. There probably does have to be more engagement on this issue and there needs to be a bit more forward planning so as to give people a taste of how it might play out. Perhaps I may speak freely. One of the appealing things is that the Scottish Parliament has, in the words of 1066 and All That, been a good thing. We find it very useful in our business. We get much freer access to politicians there than we would in London. That is all to the good and works well, but as to how it would be set up and how it would operate, I just do not know.

I would like to say a word about one particular area. Let us take energy policy. The UK operates an integrated grid and we are busy investing hundreds of millions of pounds building a new transmission line through the glens of Scotland to bring wind power down from the north to the south. I am not sure how that would work in an independence scenario because the renewable energy being generated north of the border will be heinously more expensive per kilowatt hour than the energy mix down south. I am not sure who is going to pay all those feed-in tariffs because Scotland will also need to buy baseload power going north. The idea that you can keep on pushing in vast amounts of renewable energy and that it is all going to be paid for through feed-in tariffs on consumers down in Bristol—I do not
think so. The complexity of separating out how you would handle the subsidies going to a country that is producing, or had the ambition to be so, 100% renewable energy lies in who you sell all that expensive renewable power to. It kind of assumes that England and Scotland want it. Actually, I think that that is highly questionable.

Q810 Lord Forsyth of Drumlean: Would that not be fantastic for your business? Presumably there would be more demand for generators to deal with the fall in supply.

Mr Rupert Soames: Neither Lady Kingsmill nor I need that sort of assistance in our demand. It is a pleasing thought, but I think that we can struggle on without it. We have got families here, and we want to keep the lights on.

Q811 Lord Skidelsky: In your introductory remarks, you talked about the dependence of Scotland on hydrocarbons. Some people would translate that and say that Scotland has an “oil curse”. If that is so, might not membership of the eurozone keep the exchange rate of the euro lower than it would otherwise be if Scotland were floating?

Mr Rupert Soames: Clearly, the hydrocarbon effect is going to be diluted by turning it into a much bigger zone. That in itself can have major problems with inflation. The hydrocarbon curse—as you called it, not me—is a curse that Scotland will rid itself of some time in the next 40 years anyway. It is a rapidly declining curse because there is less of it. The idea that Scotland will become the Saudi Arabia of renewable energy? What an absurd comment. Germany already has eight times more renewable energy than Scotland. The idea that you are going to be able to ship large amounts of renewable energy from the north of Scotland down to the south of France? It has to be used locally. There is a limit to how much renewable energy the consumers in England and Wales will want to buy.

Somebody told me an interesting thing: we are taxing North Sea oil at 81%, and we are paying £300 million to a single company for its renewables obligation. The difference in the equation of what you have to subsidise people for to get renewable electricity compared to what you can tax them on for the hydrocarbons is such a huge swing.

Q812 Lord Skidelsky: So, from your business point of view, it would be better, would it not, to either continue with monetary union with the UK or be in the eurozone than have a freely floating Scottish exchange rate?

Mr Rupert Soames: What, with a Scottish pound?

Q813 Lord Skidelsky: Yes, with a Scottish pound that was not tied to any other currency. That would tend to force up the exchange rate, given the hydrocarbon dependency.

Mr Rupert Soames: I find it hard to believe that we could have a manufacturing base in a country with the Scottish pound. The volatility of it against all the other currencies would be huge. I would think that whatever currency Scotland has it would have to be part of some bigger union. It would be a very difficult for Scotland to have a truly independent currency, and very difficult for manufacturers because your costs would go all over the place. We value, in our business, stability very highly.

Lord Skidelsky: I had another question, but I will stop now.

Q814 Lord Lipsey: In your earlier reference you waxed lyrical about the virtues of the Scots people: they are hard workers, entrepreneurial, with contacts all over the world. Might not therefore an advocate of independence say that if you let that wonderful group of
people free from the yoke of English imperialism, you will suddenly turn Scotland from a 1.5%-growth to a 4.5%-growth country, with prosperity forever?

**Mr Rupert Soames:** Yes.

**Lord Lipsey:** When they say it in your presence, what would you say to refute it?

**Mr Rupert Soames:** “Whatever drug you are on, I will have some too”. Life it just not like that. Aggreko is a Scottish company, so presumably we are burdened by the yoke of imperialism as well. I do not notice many yokes in Dunbarton. We are a pretty independent lot. This thing about the Scottish nation flourishing, and that we would have instant entrepreneurism because we are currently held back, is what one might politely call a myth, a fantasy, at variance with the truth and nowhere near my experience of Scottish people.

**Q815 Lord Rowe-Beddoe:** You have flattered us as a committee in saying that you have read a lot of the evidence that had been presented to us. We have been told that if a referendum on independence were approved, a number of negotiations on key issues, some of which you have alluded to, would then have to start. When you are calling for London to come to the table and start saying things, London cannot talk on many issues until it has somebody to negotiate with. It is not as simple as right and left. How do you think that we can get over the fact these negotiations could be very complex and take years? There are also examples of countries dividing and splitting quickly. How would you as a business deal with the uncertainty?

**Mr Rupert Soames:** I think that we would keep calm and carry on until it just became too unbearable. We are economic animals. We do not want to do anything, but if it all becomes too difficult, we will have to take some action. I do not share with you the view that it would be so impossible to set up some working groups.

**Lord Rowe-Beddoe:** Before or after?

**Mr Rupert Soames:** Before. This committee will presumably produce a report that will set out a thorough agenda of a lot of the issues that have to be addressed. That could be used as a bedrock to say, “Let’s go and address some of these issues, and we’ll have some working parties set up to do this”. Whether you could get the political parties north of the border to engage in that, I do not know. It seems to me profoundly wrong to treat this question with such lack of seriousness that there is not some proper preparation done to allow people to see how those sorts of debates would unfold, and their complexity. I suspect that as the committee has heard evidence from other people, you become alive—certainly I have, reading the evidence—to many different layers of complexity. Keith Cochrane talked about pensions; I had not thought of that. My God, we have a defined benefits scheme. Which side of the border will that fall on? Who will be the pensions protection agency? I thought of this in relation to energy. How are we going to split that up? These layers of complexity that we would get into would take a great deal of time. As to the idea that there will be a sudden Gadarene rush, people will be mature and grown-up and will respect the will of the Scottish people. But the Scottish people will also have to respect the right of businesses to form views about where their long-term interests lie. They will be pragmatic about this. There will not be a sudden rush for the exit. Likewise, there will not be a sudden rush for the door in if the corporation tax rate changes. Life ain’t like that.

**Lord Rowe-Beddoe:** But you might not know.

**Mr Rupert Soames:** We will not know, in which case we will hang around and wait until we do.
Q816 Lord Rowe-Beddoe: That is the point of the question. I can understand what you are saying, but you have to have two parties to start discussion. So far, there is no second party discussing this. It is megaphone diplomacy, is it not?

Mr Rupert Soames: I think so, and it is unhelpful.

Q817 Lord Hollick: You have been refreshingly candid in your responses to our inquiry. In the context of what we have described as the climate of fear that might exist in Scotland, how do you propose to carry the debate forward? To what extent do you, as a business leader in Scotland propose to be on the front foot in the debate, and to what extent do you think you will be encouraging your fellow companies based in Scotland to play a fuller role in the debate to engage, particularly over the next couple of years, on issues that are vital to your future and that of your employees?

Mr Rupert Soames: It is certainly true that youth and discretion are ill wed companions on this, and I have probably been far more open and indiscreet than I should have been and will probably end up being in trouble. I have the slightly old-fashioned view that if you are called before a Select Committee of the House of Lords, you state the position as it is, because you are talking to legislators, and this is a really important issue. You are not talking to the chambers of commerce in Alloa. It is therefore important that the Committee gets to hear views, albeit if that causes some discomfort elsewhere. It is important work that you are doing. Secondly, I think that business people will get braver. This is not only an economic decision. It is also a very emotional and cultural decision. It is a properly political decision. Businessmen make lousy politicians, just as politicians often make lousy businessmen—with notable exceptions who are sitting around this table, for example. But on the whole, I think there is a natural reluctance to want to be thought of as interfering in something that is profoundly democratic. However, there is an economic aspect to it. It is important that that is recognised and put into the pot, but it is only one part of the pot, and the Scottish people may well take the decision and say, “On the whole, we think it is more important that we should be governed by ourselves; and if Aggreko thinks that it cannot live with that, then that is its problem, not the problem of the Scottish people”. That is entirely appropriate. However, I think that the volume will step up a bit. To me, it is utterly mystifying how little coverage there has been of the evidence that the Committee has taken.

Q818 The Chairman: I hope that we might get that sorted out when we produce our report. Can I follow up Lord Hollick’s question? You may not want to answer it, but to what extent do you feel that most businessmen of your stature and with your responsibilities in Scotland share some of the robust views that you have given us today?

Mr Rupert Soames: I am not a polling organisation. I do not know. There is a wide range of views but it may be that I have a small and sad circle of business acquaintances. However, among those who I speak to, I do not think that they would have objected to anything I have said. I think that this will become clear. As the referendum gets closer, more people will get braver about saying what they really think. It will help people to understand the immense complexity of what is proposed and the huge risks. The moment you say that this might be a risky enterprise, you are then accused by people who say: “You don’t have any confidence in the Scottish people or the Scottish nation, or anything like that, and you do not like Scottish people”. It is tosh and it is stupid. It demeans the level of debate, which has to grow up—and I think it will. As Baroness Kingsmill was saying, what we need here is some more transparency. Let us put these issues on the table, let people see the complexity that will arise, and let them make their own decision.
Lord Forsyth of Drumlean: I am not leading the witness. The Government's position on, for example, quite a large employer such as you in Dumbarton—Faslane and Coulport are quite nearby—and issues such as those, is that independence is not going to happen and it is therefore not necessary to spell out the consequences in terms of cost and employment in an independent Scotland which was anti-nuclear. I am trying not to lead the witness, but do you think it is sensible to adopt such a position? The bookmakers say it is not likely to happen, and you said that some of your business colleagues took that view. The Government say it is not likely to happen, and therefore consider that they do not need to spell out the consequences of independence and leave it to the politicians. Speaking as a politician and a businessman, we do not really carry much credibility if we have a partisan view and try to set out these arguments objectively. How can we get that kind of evidence-led, sensible mature debate in Scotland if everyone is waiting on someone else to do something?

Mr Rupert Soames: Make this Committee's work be a first step to doing that. You have taken evidence on Coulport and Faslane. I think that there is a natural reluctance on the Government, in its broadest sense, to be in any way accused of bullying. There is a feeling that they must not be seen as being bullies because that will make it all the worse for them. I actually think that that is a bit wet. All my income comes from Scotland. I have huge economic interests in this and I may speak with an irredeemably English accent, but all my economic interests are centred up there. I want to know what the consequence is going to be. The idea that the Scottish people cannot be told, "Look—". Actually, the nuclear debate is well understood in Scotland because it has been so contentious around nuclear weapons. None the less, Coulport and Faslane employ, directly and indirectly, many people. It is not going to be possible for England to keep its nuclear weapons there. They will have to move. That would be one of the issues, but a whole lot of public services are currently exercised both sides of the border, and I do not know many countries that outsource their public services to other countries. There will be a flow-back both ways. I really do not think that the way to tackle this is to say, "Don't let's go and examine these facts for fear of making people feel that they are bullied". The people who feel that they are being bullied on this issue have probably already made up their minds that they have been bullied for the past x hundred years. It is the people who wish to know the facts, or at least know one angle of the facts, and everyone can come and have a debate about the facts. However, pushing the issue under the table and saying that this will be easy is not a grown-up way to address a very important and serious issue.

Lord Levene of Portsoken: As you know, it is not the purpose of this Committee to come to a view as to whether an independent Scotland is a good or bad idea, it is simply to work out what the economic implications for the rest of the UK would be. From the evidence we have heard so far, both when we were in Scotland and during the rest of the time that we have been in London, I do not think that anyone has explained to us the advantage of doing this. Apart from any emotional indications, has that argument been made in Scotland? Is it being made and are people going to listen to it? Otherwise, how are they going to make up their minds?

Mr Rupert Soames: It is not only an economic issue. Indeed, it is not even primarily an economic issue. I was mistaken in my belief that the Scottish Parliament would be a waste of time. I do not think it has been a waste of time because it enables the people of Scotland to have a layer of government that is closer to them than would be the case if it was all down in London. On the whole, I think that it has been a great success. There is an argument for saying, “One more heave and it will be more successful still”. However, I happen to believe
that that would be truly mistaken. But the fact that we can govern ourselves and have our government close to where we are is inspiring. One should not underestimate that. On the economic side, I agree, but it is wrong to see this as a debate only about economics.

**Q821 Lord Levene of Portsoken:** So the protagonists for an independent Scotland will not address the economic argument, but the emotional, feel-good national argument. That is the basis on which they would want to sell the proposition.

**Mr Rupert Soames:** Yes, because when they start addressing the economic issues, they have people who know what they are talking about saying, “It ain’t necessarily so”. I notice that the debate on the energy side is more fact based now—not much and it is nothing to celebrate—because more people whom I would qualify as knowing what they are talking about are saying, “No, life is not like that”. I would agree that the emphasis has probably been more on the heart than on the head. The path to the Scottish people taking the most important decision that they have had to take for years and years without having proper concentration on the practical impacts would be disastrous. It should not happen.

**Lord Levene of Portsoken:** So, unusually, the Scottish people would be more concerned about their heart than their wallet.

**Mr Rupert Soames:** I shall leave that.

**Q822 Baroness Kingsmill:** What it is may be a sense of neglect by Westminster, a sense of over-focus on England as opposed to Britain on many issues. That has led to a sense of, as I say, neglect and perhaps isolation on the part of the Scots. That is where the emotional toying with the idea of independence comes from, but in the end the hardnosed economic facts will speak for themselves.

**Mr Rupert Soames:** They will not speak for themselves unless there is someone who is speaking, and that is the problem. They do not have a voice at the moment. I would not comment at all on the earlier part of what you said because it would be presumptuous to do so. You have to be really careful about this. I feel very passionately about businessmen wading into areas where they should not venture. We have had that in the past, we see it in other countries, and it is deeply unattractive. Giving the economic angle a voice, which your committee is going to do, is a really important part of the debate.

**The Chairman:** Perhaps I can conclude by repeating what I said at the beginning. We are particularly grateful to you, Mr Soames, as a leading and major businessman, for focusing on the economic angle, as we wanted you to do today. You have talked about people who know what they are talking about. It is for that reason that we wanted prominent businessmen to give their views to the committee. Perhaps I may say that you have done that in a robust, wide-ranging and entertaining manner. You have said several times that there is a need for much more informed debate, particularly on the issues we have discussed today. We all share that view and we hope that our final report will make a contribution to that. I thank you very much indeed for making a contribution to us from the businessman’s point of view and I hope that we shall hear more from you. Again, thank you very much indeed for coming.

**Mr Rupert Soames:** Thank you.
Rt Hon Danny Alexander MP, Chief Secretary to the Treasury and Sir Nicholas Macpherson, Permanent Secretary to the Treasury—Oral evidence (QQ 500-525)

Evidence Session No. 11.   Heard in Public.   Questions 500 - 525

TUESDAY 16 OCTOBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Lawson of Blaby
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Smith of Clifton
Lord Tugendhat

Examination of Witnesses

Rt Hon Danny Alexander MP, Chief Secretary to the Treasury, and Sir Nicholas Macpherson, Permanent Secretary to the Treasury

Q500 The Chairman: Welcome to the Economic Affairs Committee. This is our 11th public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. We are very pleased indeed to welcome you, Chief Secretary, and Sir Nicholas, to this session. You made a very important speech, Chief Secretary, to the Scottish Council for Development and Industry last December. In it you said that “monetary and fiscal issues are first order questions that advocates of independence need to answer” and that these are “the real issues that the Scottish people have to consider” if there is a referendum. I think that we are still a long way from the full debate being public on these issues and the questions being answered, and that is the key purpose of this Committee’s inquiry. The Committee is going to Edinburgh and Glasgow next week, so this meeting is very timely for us, and I think will set the scene for many of the sessions that we will have next week. So I am extremely grateful to you for coming today. You also said in that speech that the questions that need answers are, “Using sterling outside the monetary union, who would act as the Scottish Lender of Last Resort? Outside the monetary union, would
Scotlands have the fiscal power to support its financial system?”, and, “With independent fiscal control, would Scotland have the power to respond to shocks to its economy without racking up unsustainable debt?” You then went on to say, “It is those risks and those complex considerations that mean the question of currency has to be at the centre of any debate and any referendum on independence”. We would agree with that, from all the sessions that we have had so far. In that speech, you made the case that monetary union cannot coexist with fiscal independence. In fact, you and the Chancellor have both described this in the European context as “remorseless logic”. Why in your view is not possible to have monetary union and fiscal independence in the long term?

**Danny Alexander MP:** Lord Chairman, may I start by making a few preliminary observations? They will not take long, but they will help to frame the conversation in exactly the way you just have. Obviously I am here as Chief Secretary to the Treasury, but also as a proud Scot and Member of Parliament for Inverness, Nairn, Badenoch & Strathspey. So I have a number of direct interests in this matter. The Prime Minister and the First Minister yesterday signed an historic agreement to give the people of Scotland a referendum, so this issue will in due course be resolved. It is my belief that the legal, fair and decisive referendum that that agreement allows to happen can put this issue to bed for a generation. But you are right to say that it is a long road. The referendum is two years away, or so. You also said that those who advocate independence are still not at all clear in many respects what they mean by that, and a lot of the big questions are unanswered. To support this, the UK Government, led by Her Majesty’s Treasury, is undertaking a large programme of analysis to establish a robust body of evidence to inform the debate on Scotland’s place in the United Kingdom. It is also why this Committee’s inquiry is so timely and so important. I have never been one of those who argue that Scotland cannot become independent, but I firmly believe that it is not the best option for those Scots who, like me, think that economic security and future prosperity are our first aspiration for Scotland. You mentioned my speech to the Scottish Council for Development and Industry last December, and on that occasion I spoke about the currency issue as I said. The Scottish Government’s latest position—although their position seems continually to evolve—is that an independent Scotland would seek to enter a formal currency union with the rest of the United Kingdom. That position ignores the fundamental challenges that confront the Scottish economy and the UK economy as well as the global economy. As I said, the remorseless logic of the eurozone crisis ignores that logic, which is that you cannot have monetary or currency union—you correctly pointed out the distinction—without greater fiscal and political integration. Those who propose independence are still yet to address that fundamental point months after those questions have first been posed. I make one other observation: it is not just on the currency but on fiscal and financial services and other areas of the economy where as part of this debate we must confront the realities of the world that we actually live in. Independence is a one-way ticket; there is no going back. With the long-term fiscal challenges of declining natural resources and an ageing population, the people of Scotland will have to consider not just what is best for them today but what is best for our children, our grandchildren and our great-grandchildren. I firmly believe—and I appreciate that this Committee does not take a view and is undertaking a dispassionate analysis—that in a United Kingdom of greater scale and diversity and a poorer fiscal base we are much better placed to meet today’s economic challenges and to achieve prosperity together. We would all be much weaker apart. Those are the issues that I think are the most important ones.

Q501 **The Chairman:** Thank you very much for that. We will certainly be covering some of the other issues that you have mentioned in our questioning. I turn to the issue that I
raised with you as to why in your view it is not possible to have monetary union and fiscal independence in the long term.

**Danny Alexander MP:** You just have to look at what is currently going on in the eurozone. I made that speech back in December at a time when those issues were at a particularly critical point. We have seen a number of critical points, and those issues are still yet to be resolved. What that has shown is that to have a common currency without common fiscal arrangements or institutional arrangements, and arguably without common political arrangements, creates all sorts of tensions and difficulties that could be exacerbated in times of economic stress. The idea that within the United Kingdom we would seek to recreate all the initial failings of the eurozone is not a wise way to go forward, yet that could be taken to be the implication to the limited extent of the SNP’s proposals to which they have so far been described. I have said before and say again: if you want to have the benefits of a common currency, having a shared fiscal policy and shared political arrangements and so on is by far the best way in which to achieve that. In the UK context, that means that retaining the United Kingdom is the best way in which to continue to have the benefits of a single currency within the UK.

**Lord Forsyth of Drumlean:** I agree very much with that point that monetary union cannot exist with fiscal independence. You described that as “remorseless logic” in your speech, but how then could the idea of fiscal autonomy operate? Would that not be the same position as with independence? Would there not be the same difficulties, that you would have one part of the United Kingdom setting different tax rates, and so on? Therefore, the so-called devo-max option suffers from exactly the same criticism that you made of independence.

**Danny Alexander MP:** That depends on the nature of arrangements. Again, that is a slogan with a range of different possible ideas under it, which have not been crystallised into any one particular form. But if you take as your starting point the Scotland Act, which we have just passed and which will be implemented over the next few years, that gives a substantially greater degree of devolution of tax-raising powers to the Scottish Parliament—personal taxation as opposed to those taxes that are integral to the UK single market—and some borrowing powers, but under very strict limits. There are on the face of the legislation limits on those borrowing powers, which prevent the possibility that under those arrangements the Scottish Parliament could run up unsustainable borrowing that then became an obligation on the rest of the UK.

**Lord Forsyth of Drumlean:** So to go further is not a practical possibility?

**Danny Alexander MP:** I think that there are some ways in which you could go further. You could go further in terms of personal taxation. I would not want to go further in terms of business taxation or those taxes that matter most to the integrity of the United Kingdom single market. But you could go quite considerably further in terms of personal taxation. The point would be that within the United Kingdom—by the way, this point also applies to the argument that we are considering here that an independent Scotland can none the less share a common currency but not have any fiscal arrangements—the danger is that you would end up with a position where, just as we have seen in the eurozone, some countries run up excessive borrowings and have to call on other countries. That is precisely why at the moment ever stricter rules are being proposed, discussed and put in place in the eurozone, which require surveillance, permission and certain sorts of policies to be followed. That is, if you like, the remorseless logic of a currency union between different countries, which applies just as strongly to this as to the European case. Do I think that that means that you
Rt Hon Danny Alexander MP, Chief Secretary to the Treasury and Sir Nicholas Macpherson, Permanent Secretary to the Treasury—Oral evidence (QQ 500-525)

cannot devolve further powers within the United Kingdom? No, I certainly do not think that that is what it means.

**Q503 Lord Lawson of Blaby:** Perhaps I may follow up Lord Forsyth’s question. Like him, I entirely agree with your analysis; it is a remorseless logic and it always was a remorseless logic, but it is quite useful that the eurozone debacle has provided such a lively practical example of the facts of life. There is another problem, quite apart from differences in structure of taxation, which there might be in an independent Scotland. It is always possible—it may not happen—that one of the two countries, Scotland and the rest of the United Kingdom, might be more prosperous than the other. Under the existing system, there is a single system of taxation and benefits; automatically, without any discretionary moves, there are transfers from the wealthier parts to the poorer parts. Nobody kicks up a fuss about that; it is an aspect of national solidarity. It is not explicit—it happens automatically. It is automatic within the United States; it has a very successful currency, but parts of the United States are very wealthy and successful and parts are less so, and there are transfers all the time. Once you have independence, these transfers need to be specific. As we have seen with the eurozone, they need to be voted on, which causes huge political problems and, indeed, there may be an unwillingness for the necessary transfers to take place. I am not saying that there would be a difference in the wealth and prosperity of the two parts of the present United Kingdom, but it is perfectly possible that that might arise. Therefore you have a real problem.

**Danny Alexander MP:** You make a very important point. It is certainly the case that resilience in the face of asymmetric economic shocks within the United Kingdom is one strength of the current arrangement. Scotland has the benefit of a wider United Kingdom that has a very strong fiscal base, with a great degree of credibility in the financial markets, allowing us to borrow at low rates. If there is a particular shock that affects a particular part of the United Kingdom, the automatic stabilisers that operate UK-wide—the transfer payments through the welfare system and resilience to lower tax receipts from a certain part of the country—cushion that impact and help to take that part of the country through that difficult situation. Clearly, those transfers would not be available in the context of an independent Scotland; certainly, there are no proposals from the SNP to put in place such transfer arrangements, and clearly there will be people across the rest of the United Kingdom who might have an opinion on that subject. I think that that is important too in the context of understanding the challenges to the medium-term fiscal sustainability of Scotland as a single unit, as opposed to part of the wider United Kingdom. We might come back to this, but I draw two issues to the Committee’s attention. The first is one that I know you have had a lot of discussion about with previous witnesses, about the volatility of oil revenues and their declining nature over time. The other is about demography. I have some interesting information that I would be very happy to share with the Committee. Scotland is at a different stage of the demographic transition; Scotland already has an older population on average than the rest of the UK and has fewer working people per retired person. We are a generation ahead of the rest of the UK in terms of that demographic squeeze. The consequence of those two things—the volatility on the tax side and the further advance on the demographic side—would mean that whoever carried out the Finance Ministry function in an independent Scotland, if that ever occurred, would face difficult decisions for a very long period of time indeed. I and colleagues on the Committee have experience of taking difficult financial decisions in government, but to have to do so for a period of five, 10, or 20 years to meet those pressures would be a very difficult situation indeed.
Sir Nicholas Macpherson: Perhaps I could chip in briefly. We have the real historical example of Ireland in the 1920s and 1930s. Northern Ireland, on the one hand, had social security powers devolved to it, but probably very wisely it has always chosen not to exercise those powers. You had, originally, the Irish Free State and then the Republic to the south, which entered into a monetary union that lasted 50-odd years. It was not a formal one but a currency board. Ireland had the sort of demographic problems in the 1920s to which the Chief Secretary referred; therefore it also had to pursue a credible economic policy and run a very tight fiscal policy. Therefore, it had to cut the value of the state pension in Ireland in 1924 to keep those public finances on track. That exemplifies exactly the sort of issues to which the Chief Secretary refers.

The Chairman: On the demographic issues, we obviously have a lot to explore with you today. It would be very helpful if you could give the Committee a note on the work that you have been doing on the demographic issues.

Danny Alexander MP: It is very striking. I will happily give you a note—you can have the note that I have been given by my officials, unless they tell me that there is something here that you cannot see, although I do not see why there should be. Scotland is expected to increase from having 25.8 over-65s per 100 people of working age today to having 51.7 in 2060. The rest of the UK has the same ratio today, but it only increases to 45.9 in 2060. In other words, by 2060 Scotland expects to have 1.9 people of working age for every over-65 compared to 3.7 today and 2.2 in the rest of the UK. So it is quite a significant difference.

The Chairman: A further note would be very helpful.

Q504 Lord Tugendhat: I am glad that you have just mentioned Ireland, because it is important that we should draw conclusions from what is happening in the eurozone, as that crisis is unfolding before us, but it is also important that we should look at simpler unions. The eurozone is very complex, involving 17 countries, while the situation with Ireland and the UK involves two. But there was another monetary union at the same time as the British and Irish one, which was between Belgium and Luxembourg. I am not at all an authority on Belgium and Luxembourg, but I remember from when I lived in Brussels that there were quite a number of differences in tax structure between the two countries. I do not know whether you have examined that relationship and drawn any conclusions, but that, too, is relevant, especially as in that case you had two countries of broadly speaking the same level of wealth. If anything, the smaller one was wealthier than the larger one.

Danny Alexander MP: Perhaps I may make an observation, after which Sir Nicholas may wish to add something. First, I would caution against taking against any specific historical example and drawing too direct conclusions to the Scottish case. Ireland in the 1920s is a very different proposition to Scotland today, as is Belgium and Luxembourg in the period when they had monetary union. There are other much more fundamental dissimilarities, if you like. On the issue in relation to Scotland, you made the point about the similarity of the overall economic position. One feature of Scotland within the United Kingdom at the moment is that, if you look at the macroeconomic statistics, it is more similar to the United Kingdom average than is any other part of the United Kingdom. Scottish GDP is 99% of UK GDP, and unemployment figures are broadly very similar and have been for a period of years. That suggests to me that the current arrangements work very well for Scotland. One risk of changing is in some areas in which Scotland differs. I mentioned oil and the volatility of that sector; the energy sector is a very great strength for Scotland, and the move to renewable energy might be a further strength, although again that is supported by consumers across the whole of the United Kingdom.
Q505 Lord Tugendhat: To come back to the speech that you made, you talked about pooling risks and risk-sharing capability between Scotland and the rest of the UK so that a shock to one region can only be offset by a transfer payment from the unaffected region, and vice versa. Does this not require the economies involved to have quite different structures, so that a shock in one may affect one region but not another, whereas, as you have just indicated, the structures between Scotland and the rest of the United Kingdom are extraordinarily similar? The question is whether you were making a substantive point or an academic point.

Danny Alexander MP: There are a number of substantial points. The first is that those figures suggest to me that the monetary policy set by the Bank of England for the UK as a whole, with Scotland as part of the fiscal, monetary and political union that is the United Kingdom, is well adapted to the needs of the Scottish economy. But of course, there are differences, which sit underneath that. I mentioned oil and gas and the risk of being more exposed to negative shocks in terms of price and production in an independent setting than in the United Kingdom. Another example might be that, in the 1990s, Scotland specialised very successfully in manufactured electronics, with the so-called Silicon Glen, but suffered a big negative shock in the 2000s due to the global collapse of the ICT bubble.

Lord Lawson of Blaby: Banking and financial services is another one.

Danny Alexander MP: It might well be another example, and maybe I will come back to that as we go along. It is a very important discussion to get into. There is a secondary point, which is also substantial, which is that Scotland currently has an economic cycle that is very similar to the rest of the UK, as a fully integrated part of the UK economy. In the event of independence, that might well diverge, which could well cause these risks to which I referred in my speech to emerge more strongly.

Q506 Lord Smith of Clifton: Chief Secretary, if there were an independent Scotland, do you think that there would be any likelihood of arrangements being made whereby the Bank of England could have responsibility for providing services such as lender of last resort to the Scottish-based institutions? You appeared to suggest in your December speech that the Bank of England could provide these facilities inside a monetary union. Can you elaborate on that?

Danny Alexander MP: The first thing that I would say is that it is for the Scottish National Party and the Scottish Government to set out what their view is of the arrangements under independence. It is not for me to set out how they could work. The UK Government are engaged not in contingency planning for these arrangements—we are not trying to pre-negotiate the results of a referendum—but we are engaged in providing information and making arguments to persuade people in Scotland that the right and best solution for the Scottish economy, and for a wide range of other reasons, is to remain part of the United Kingdom. Given that Scotland has a large financial sector—it comes back to Lord Lawson’s point—the crisis that we have been through should, if anything, have demonstrated very directly to people the size of that financial sector and the range of activities that
Governments then need to take part in to secure that financial sector in difficult times. It is rather surprising to me that the Scottish Government have not been clear at all, so far, on how they propose that a lender of last resort function should operate. I know that you are seeing the Scottish Government as part of your inquiry—maybe you are not? I had understood that you might be.

**Lord Forsyth of Drumlean:** I think that the First Minister has declined to tell us.

**The Chairman:** We asked the First Minister to come to our hearings in Edinburgh and Glasgow, but he has been unable to do so. We will be hearing from Mr Swinney in due course.

**Danny Alexander MP:** The First Minister may be worried about answering these questions directly at the moment, but he shall have to over the next two years if he is in any way to present a credible case. This is one of the key areas. As the crisis has illustrated, in the UK we benefit from a strong central lender of last resort in the Bank of England, as part of the wider UK economic framework. The answer to your question would depend on what sort of monetary arrangements an independent Scotland would choose to adopt. I set out in my speech four different options which they might consider, and which the SNP has advocated at different times, from joining the euro, to a currency union, to some form of “sterlingisation” mechanism, perhaps, in the way that Montenegro currently uses the euro. How this would operate would depend very much on the answer to that question.

**Q507 Lord Lawson of Blaby:** May I follow this up? I agree with everything you said except when you said that this was a matter for the Scottish Government or the SNP, or whatever, to decide. It is not.

**Danny Alexander MP:** I did not say that it was a matter for them to decide. I said it was a matter for them to set out what their position was. That is an entirely different thing.

**Lord Lawson of Blaby:** I think that we would like to know your position. The Bank of England, after all, works within the remit of various Bank of England Acts, which are Acts of the United Kingdom Parliament. So it is a matter for the Parliament of the United Kingdom to decide what relationship, if any, there should be between the Bank of England and an independent Scotland. So what do you think the relationship between the Bank of England and an independent Scotland should be? It is not just a matter of lender of last resort. It is also a matter of monetary policy and a whole lot of other things.

**Danny Alexander MP:** I think that the relationship of the Bank of England to Scotland ought to be exactly as it is at the moment: that the Bank of England should be the central bank for Scotland within a unitary United Kingdom.

**Lord Lawson of Blaby:** I was not very clear. I asked what you thought the relationship should be between the Bank of England and an independent Scotland should be? It is not just a matter of lender of last resort. It is also a matter of monetary policy and a whole lot of other things.

**Danny Alexander MP:** I think that the relationship of the Bank of England to Scotland ought to be exactly as it is at the moment: that the Bank of England should be the central bank for Scotland within a unitary United Kingdom.

**Lord Lawson of Blaby:** I was not very clear. I asked what you thought the relationship should be between the Bank of England and an independent Scotland should that arise.

**Danny Alexander MP:** That is a matter, should Scotland vote for independence, for agreement between the respective authorities at that time. My point, which I was making in response to the earlier question, is that we currently have no clear proposition on the table. What we have is a range of different things that have been said on this subject. What I have sought to do in my speech and in my evidence here is to point out the risks associated with any of the options that have been floated, which lead me to the conclusion that the most optimal arrangements for Scotland in terms of its monetary and central banking arrangements are the current ones.
Rt Hon Danny Alexander MP, Chief Secretary to the Treasury and Sir Nicholas Macpherson, Permanent Secretary to the Treasury—Oral evidence (QQ 500-525)

The Chairman: We have some more specific questions in relation to the Bank of England coming later. Perhaps we could wait for those.

Q508 Lord Forsyth of Drumlean: Just on the lender of last resort, perhaps the Chief Secretary could help me. Why would the rest of the United Kingdom’s taxpayers want to stand behind the central bank, the Bank of England, for it to be lender of last resort to a foreign country?

Danny Alexander MP: That is a very good question.

Lord Forsyth of Drumlean: Which I was hoping you might answer.

Danny Alexander MP: It would have to be addressed at the time. What you are quite rightly pointing out is that there are very severe risks in relation to this. The idea that you can rest a case for independence on this argument is precisely shown to be problematic by the nature of your question.

Lord Forsyth of Drumlean: I am asking whether you can think of any circumstances under which that would be possible.

Danny Alexander MP: Again, we have a real-life example of this. This debate is currently going on within the eurozone where, as a consequence of the difficulties in this respect, they are currently debating having a banking union within the eurozone. That subject will be debated at the European Council this week and no doubt for many months to come. It shows the dangers for financial stability of proposing a currency union without deep fiscal union exercised between the members of it. I do not think that it is for me to come up with a preferred option for how an independent Scotland should operate. That is for the SNP to provide. They have not answered any of these questions.

Q509 The Chairman: Of the four possibilities that you have put forward, presumably in the Treasury you are considering at the moment how you would respond to each of those. You may not wish to indicate now, but it would be helpful if you could, what conditions you would lay down on each of these individual options.

Danny Alexander MP: We are not engaged in contingency planning for what would happen if Scotland voted to be independent. We are engaged in analysis of the strengths of the arrangements within the United Kingdom, and the risks to both Scotland and to the United Kingdom of disrupting those arrangements in order to ensure, precisely as you said at the outset, that there should be a well informed debate in Scotland. We are not engaged in contingency planning to work through, in all these scenarios, what our preferred negotiating position would be. We are seeking to provide evidence and make a case.

The Chairman: In fact, if any of these four scenarios become real, there are huge implications for the rest of the United Kingdom in the response that the Bank of England has to make.

Danny Alexander MP: There are.

The Chairman: Surely what that response would be is one of the issues that must be made clear before the referendum.

Danny Alexander MP: It would be a matter, should Scotland vote to become independent, for agreement between the authorities. There is a whole range of issues which this exposes, many of which I have set out in my speech and here.
Q510 Lord Lawson of Blaby: I am slightly surprised. We are not talking about a question of negotiations. We are asking what would be the relationship between an independent Scotland and the Bank of England should the people of Scotland vote for independence; if they did, that would happen. Suppose, for example, that the SNP were to say something that you might consider to be a cock and bull story; for example, that they would be fully represented on the Monetary Policy Committee and ensure that monetary policy was entirely fitted for Scotland. Are you just going to sit back and say nothing if you think that they are talking nonsense? They may be talking sense, I do not know. But we want to know where you stand.

Danny Alexander MP: No, I am certainly not going to step back if I think that they are talking nonsense. That is the whole basis of the arguments that I have been making here. What this points out is that, in fact, when you get under the skin of these arguments, whether it is currency arrangements, monetary policy arrangements or central banking functions, you discover that the case for independence falls down because it is based on the argument that you can have, somehow, complete fiscal autonomy for an independent Scotland yet somehow engage in common monetary arrangements between Scotland and the remains of the United Kingdom, which is demonstrated by the experience of the eurozone to be totally impractical.

Lord Forsyth of Drumlean: You and I live in Scotland and are going to have to vote in this referendum. I want to know, if there is a requirement for the Bank of England to be lender of last resort, whether that will be available or not. It is a very simple question.

Danny Alexander MP: There is no requirement for the Bank of England to be the lender of last resort.

Lord Forsyth of Drumlean: Will the Bank of England be able to be the lender of last resort? I would have thought not, because English taxpayers would be providing a guarantee to a foreign country if the Scots had voted for independence. You need to tell us whether that is the case or not.

Danny Alexander MP: I think that I have dealt with that point but if, on reflection, I think that there is more that I could say to the Committee then I will certainly do so.

Q511 Lord Smith of Clifton: May I reclaim my question and ask a supplementary? It is always very difficult with all this hijacking going on. I accept that you want to maintain the integrity of the United Kingdom, and so on, but is there a situation that is the opposite of what Lord Forsyth is saying—although I agree that there is a lot of force in what he says? Is there any advantage to the rest of the UK to enter into some sort of relationship in banking regulation with an independent Scotland?

Danny Alexander MP: I think that there are both significant dangers and some legal impediments, so European law requires each individual member state in the event that it is a member of the European Union, which is part of the Scottish National Party’s case, to be a competent authority in respect of financial services regulation. Some of those functions are pooled at a European level, while others are carried out by national regulators. So you have one set of risks there. For example, how would you handle the business of providing compensation to deposit holders in circumstances when a financial institution collapsed? We have a UK financial services compensation scheme. It would certainly be a requirement for any competent authority to put in place a similar scheme on a Scottish basis. Financial institutions would have to ask themselves and take a view about the strength of the fiscal authority that sits behind that compensation scheme and its ability to meet obligations for a
Lord Lipsey: Can I just turn to the spending side of the fiscal equation for a minute? The Scottish Government have adopted policies that you as Chief Secretary would not contemplate adopting for the rest of the United Kingdom. To take a particularly salient example from the demographic figures that you gave earlier, there is free personal care for the elderly, whose cost has more than doubled since the policy was introduced a few years ago. It is possible to argue that they only do that because we give them a lot of money through the Barnett formula, but it is also quite possible to argue that they do it because Scottish political culture is in some sense more disposed to government spending than that of the rest of the United Kingdom. Would you expect this high-spending culture to continue if there was independence for Scotland, when you would not be in a position to influence it, and if it did continue would that be bad news for the Scottish economy?

Danny Alexander MP: The first thing to say is that if Scotland became independent the Barnett formula and so on would cease to operate, as previous witnesses have said. Secondly, the idea of Scotland becoming independent is being contemplated at a time when, as the United Kingdom, we are still running substantial budget deficits, which means that the total amount of debt to be serviced is currently rising. It is forecast to peak in 2015, which is around the time of the 2014 referendum, when the question is envisaged to be addressed. So with a country running a budget deficit—the same would be true of Scotland—taking on a significant proportion of a large amount of debt, that already presents very serious fiscal challenges. Various things are said that imply that the view is that one could both engage in high-spending policies and also cut taxes in various areas, which would lead to a significantly larger budget deficit. Clearly, those would be decisions for whoever was elected to the Government of Scotland under those circumstances. My observation would be that such a Government would be presented with very significant fiscal challenges almost immediately because of the degree of debt that the United Kingdom would have—but with the deep pockets of the United Kingdom and the well established deep, liquid and credible bond markets in the United Kingdom, and the credibility in these matters that this Government have established, we are able to borrow at record low rates. There is a very good question to be asked about what view the credit rating agencies would take of a newly established state without a fiscal track record, what interest rates would therefore be payable on a new debt issued by a Scottish Government and how that would affect the debt dynamics and fiscal sustainability before you got into the question of what the policy choices would be under those circumstances. I do not presume to speak for the credit rating agencies—I have said publicly that I do not think that their views are the be-all and end-all of economic policy, and nor should they be. But looking at what some of the rating agencies have said about how they would view newly established states of any sort would lead you to think it was a further serious fiscal issue for a newly independent Scotland to contemplate.

Lord Lipsey: I do not want to put words into your mouth, but you are almost saying that there is a very strong chance that there would be an immediate financial stability crisis in Scotland if they got independence.

Danny Alexander MP: That would be putting words into my mouth, and I would not accept them, as it were. But I am pointing out that there are some serious risks. The point that I made in my opening remarks is also important. It is easy to say, “Let’s focus on what the state of affairs would be on day one”. That is obviously a very important question. But what should be in Lord Forsyth’s mind and my mind as we cast our votes, and in the minds of millions of other Scots as they cast theirs, is not just what the state of affairs will be on
day one, but what it will be in five years', 10 years', 20 years' and 50 years' time, because what we are being invited to take is an irrevocable decision that will affect my children and my children's children. That is the reason why I made the argument earlier about long-term fiscal sustainability. All these issues, no matter how difficult, can be dealt with by Governments; our Government are currently making very difficult decisions to deal with very similar problems. But the idea that suddenly all those decisions will get very much easier overnight, simply by voting to become independent, is just false.

The Chairman: But I think that you are implying in your answer to Lord Lipsey that very early on under independence the Scottish Government would face much higher borrowing costs.

Danny Alexander MP: Maybe Sir Nicholas would want to comment on this, but one thing that any newly independent state would have to do is to establish arrangements for issuing debt. Those arrangements by definition take time to establish and to have their credibility built up, which of course has an effect on the interest rates.

Sir Nicholas Macpherson: Just to add to that, I think that there are two angles to that. Even countries that are pursuing incredibly credible and tight fiscal policies, such as the Netherlands and Finland, pay a premium on their debt compared to Germany. So even on day one, if Scotland was pursuing a surplus, there would probably be some sort of premium. The second issue is the one on which I highlight the Chief Secretary’s point. Britain has one of the deepest capital markets in the world; the average maturity length of debt in the G7 is something like six years, and in Britain it is 14 years. On day one, Scotland will have to go into the market; it will not have the track record of the UK authorities, the sophistication of our debt management operations, or the extraordinary length of our yield curve, all of which means that it will face quite big risks, as the Chief Secretary says.

Q513 Lord Rowe-Beddoe: Chief Secretary, returning to your December 2011 speech where you said that being part of the union was Scotland's long-term economic anchor and dismantling the union would create uncertainty and loosen the anchor, is there any hard evidence that Scottish financial institutions are concerned about the consequences of possible new financial arrangements between an independent Scotland and the rest of the UK?

Danny Alexander MP: I think that there is some evidence of that. For example, you could look at the comments that the Confederation of British Industry made. Just this year, John Cridland, the director-general of the CBI, spoke at the CBI Scotland annual dinner, where he made it clear that the view collectively among business members is that they are not convinced of the business and economic case of Scotland seceding from the union, as they put it. There is a wider point that this draws out. I have said before that the SNP needs to be clearer on the nature of its proposals for an independent Scotland and the rest of the UK.

Q514 Lord Rowe-Beddoe: So the uncertainty is something that is likely to increase between now and 2014, no doubt. But how can we put that uncertainty away? Would such provisions be contained in a Bill of the Scottish Parliament that would be available before people were asked to vote in a referendum?
Danny Alexander MP: With respect, I think that that is a question for the Scottish Government to answer. Yesterday, Mr Salmond was talking about setting out a prospectus nearer the time, so it may be that they would seek to answer some of those questions here. The financial sector is one of Scotland’s enormous strengths within the United Kingdom and one of those areas in which Scotland has been able to excel, but recently the total support given by the UK Government to the Royal Bank of Scotland has amounted to £320 billion, or 21% of UK GDP—so it is pretty significant for the UK—which would be 211% of Scotland’s GDP. So I think you get a sense of the sort of issues and risks that would be at stake. Depending on how you measure it, the total liabilities of the Scottish financial sector are about 14.5 times Scotland’s GDP, so clearly the way in which an independent Scotland answered some of the questions about that would be of very direct interest to one of the country’s most important industrial sectors.

The Chairman: We will be having hearings in Glasgow and back in London with some representatives of Scottish business, financial institutions and so on.

Q515 Lord Hollick: I shall stick with banks and the question of how banks are regulated. If an agreement were reached whereby the Bank of England provided services such as clearing and lender of last resort facilities, do you think that it would be necessary for the Bank of England to regulate Scottish institutions?

Danny Alexander MP: Decisions about how to regulate industries are core decisions of an independent state, and that is particularly the case in relation to the financial services industry, which is so directly linked to the rest of the economy. I made the point earlier that an independent Scotland, if it was part of the EU, would be a competent authority in the terms of European law in this area, so it would not be possible simply to hive off all those activities to somebody else. There would be areas—and I mentioned compensation schemes earlier—which would definitely have to be functions of an independent Scotland. What that says to me, to make the positive case, is that the interdependence that we have within the United Kingdom is a better solution for that industry and for the Scottish economy than independence, because it begs so many questions that simply have not been set out by those who advocate independence.

Lord Hollick: Does not this become slightly moot when under the proposed European banking union there will be a single supervisory mechanism, which will apply to all financial institutions whether they are within the euro or not, as long as they are part of the European Union?

Sir Nicholas Macpherson: The way in which negotiations are developing in Europe mean that it will be the European Central Bank that regulates the banking industry across the eurozone. I can assure you that it will not be done through regulation in the United Kingdom. There is a separate issue around Scotland’s relationship with the European Union in the event of it becoming independent, which is a matter of great debate among the experts in jurisprudence.

Danny Alexander MP: In answer to the question about banking, the banking union is currently being negotiated and the negotiation is not concluded yet. It does not seem that the banking union proposals suggest the abolition of national regulators nor that there are certain functions that would not need to continue to be carried out, even if a country was a member of that banking union, by national regulators. So there would still be a need for it in any model. There is no precedent, as far as I am aware, of one country seeking to use the regulatory functions of another, completely. As I said, there are functions like protected depositors in financial institutions, for example, which clearly have to remain part of a nation
state, because they rely so heavily on the fiscal authority that sits behind it. So there is no
answer to this question that is coherent and operates as the SNP has so far suggested.

Sir Nicholas Macpherson: There is a related issue, which is a point that I wanted to raise
earlier. It is tempting to focus just on the banking side of financial services, but actually
Scotland’s great successes have been in asset management, insurance and so on. It is striking
how integrated the Scottish market is with the rest of the UK. I have a figure that certainly
impressed me, which is that insurers based in Scotland sell 6% of their product to Scottish
postcodes and 94% to the rest of the UK. In mortgage markets, 16% of mortgages sold by
Scottish firms were to Scottish postcodes and 84% to the rest of the UK. This is a classic
highly integrated market, and having two regulators would become a great obstacle. Yet as
the Chief Secretary pointed out, to have a single regulator covering two independent
countries would pose a number of challenges.

Danny Alexander MP: And even if you did have one regulator, there would no doubt be
differences in national law. To say that the regulator would carry out the f
unctions in
Scotland but under legislation established by a foreign power without any ability to affect
that would be highly unusual. Then you would face a situation whereby businesses in the
sector, even if they were regulated by the same body under slightly different legal
frameworks, would face additional costs of complying with both those frameworks. That
again would be an issue highlighted by the statistics that have just been cited.

Q516 Lord McFall of Alcluith: Let us suppose that there is a single financial regulator to
the rest of the UK in an independent Scotland. Could an independent Scotland pass laws
that would undermine the single regulator’s best endeavours? We have seen in Europe national
champions—and in Scotland only recently we saw the First Min
ister espouse the Royal Bank
of Scotland as a national champion, with his letter on ABN AMRO telling it to go ahead. So
we remember that. In the event, would the rest of the UK regulator be thought to have
failed and hence the UK taxpayer pick up the bil
l?

Danny Alexander MP: First, it is of course theoretically possible at least, although only with
the agreement of the rest of the UK, that an independent Scotland might want to ask the
Prudential Regulation Authority and the Financial Conduct Authority to be the regulators.
That is the theoretical possibility, but it would not allow those firms to be regulated on a
UK-wide basis, because you would have different bodies of law and Parliaments and fiscal
authorities sitting behind that. We are making strenuous efforts to ensure through the
regulatory changes that we are making UK-wide that we do not ever again have to bail out
banks in the way that we have, and there would be no obligations on a UK Government
under the circumstances that you describe.

Q517 Lord McFall of Alcluith: But Sir Nicholas said that there would be problems with
a single regulator. Maybe one I could highlight would be, say, the Scottish Government taking
different attitude on foreclosing mortgage arrears regulations. If the rest of the UK financial
regulator had a different policy, the question is who picks up the Bill on that?

Danny Alexander MP: Those would have to be issues that were the responsibility of the
Scottish Government. You make the point that I made earlier, that asking one regulator to
carry out regulations on the basis of two different legal systems is theoretically possible but
in practice extremely difficult.

Lord McFall of Alcluith: So we would get into a real mess in a lot of areas, that is what
you are saying.

Danny Alexander MP: Yes.
Lord McFall of Alcluith: Good, that is fine. Nicola Sturgeon was on last night and she swept aside the point about being part of a monetary authority and the Bank of England by saying that Scotland would still have great latitude and fiscal independence. How much fiscal independence would Scotland have if it had a monetary arrangement with the Bank of England?

Danny Alexander MP: This goes right back to the original point about the example of the eurozone right now. That is the very problem with which eurozone countries are wrestling—that a common currency without any degree of fiscal integration in the end runs into the sorts of difficulties being faced now. You can look at the fiscal compact and the various other arrangements that are already being put in place at a eurozone level—and that is just the start, I suspect—with balance budget rules, surveillance of national budgets, permission having to be given for certain policies, and so on. Those are the sort of things that have been discussed within the eurozone. The idea that anyone would want to see the initial arrangements of the eurozone, which were complete fiscal autonomy with a common currency, recreated on these islands—you would have to be completely potty to advocate that.

Lord McFall of Alcluith: So it would be pretty limited, that is what you are saying.

Danny Alexander MP: There would need to be clear fiscal arrangements in place.

Q518 Lord McFall of Alcluith: Yes, well—pretty limited. Sir Nicholas, you and I have discussed over many years the issue of lender of last resort. When the Civil Service looks at that issue—and here and I am trying to add to the frustrated attempts of Lord Forsyth and Lord Lawson of questioning you on this—what would the gravity of the decision be within the Treasury in a situation like that? Would they just say, “It doesn’t matter, let’s go ahead with this”? Or would your hair turn even greyer and get baldy?

Sir Nicholas Macpherson: I can remember appearing before you many times, Lord McFall, during the financial crisis, and one thing that I did learn through that period is that you need to have very efficient decision-making. You are taking decisions involving huge amounts of money under huge uncertainty, and you need arrangements that work. We can all argue about whether the FSA and the tripartite arrangement is the best way through, but all the work of your Committee and all the Government’s attempts to reform the system since are about trying to create a better system for taking really difficult decisions at a time of national crisis. So from a Treasury perspective, whatever happens in the coming period, we will need real clarity on these issues. These are not problems that you want to discover in the eye of the storm.

Q519 The Chairman: Sir Nicholas, can I go back to one of the points that you made about the proportion of business in the Scottish financial institutions in the rest of the UK compared to in Scotland? What conclusions can you draw from that? Is it that if the institutions did not like the regulator in an independent Scotland, they would be very tempted to base their business elsewhere?

Sir Nicholas Macpherson: You are going to Edinburgh, and I was in Edinburgh last week talking to some of the same people, I suspect, to whom you will be speaking. For perfectly understandable reasons, at an institutional level—I am thinking of Scottish financial enterprise here—they are not going to take a position on the independence issue, but it is very clear that they want some answers to some of the questions that we have been discussing today about regulation, the European Union and the role of the central bank. Ultimately, companies within Britain have total choice as to where their head office is
located, because ultimately, whether it comes down to regulation or tax, it makes little or no difference. In the event of independence, these will be critical issues. You will know from your own experience and at the Treasury that the capacity for financial flows and business to move is perhaps greater when it comes to financial services than in any other industry. You are identifying important issues.

**Danny Alexander MP:** The point that has been made to me by some participants in the wider financial services sector—the insurance industry, for example, is particularly significant in Scotland, and that is a very good thing; it is an area in which we have a great deal of expertise—is that being separated by a national border from the vast majority of your customers is not necessarily a comfortable place to be.

**Q520 Lord Tugendhat:** I take up the point that Sir Nicholas made on the European Union and the desire of Scottish financial institutions to have answers to some of the issues that relate to that. We have heard Mr Barroso say that in his opinion an independent Scotland would need to negotiate its way into the EU. Of course, the issues that arise in Scotland at the moment happen also to be arising in a different context in Spain with Catalonia. This can only be your opinion, but do you think that the European Commission would feel that it was able to give advice on matters of this kind to the SNP and its Catalanian equivalent, or do you feel that in these matters it would think that it ought to stay out until the votes had actually been taken—in other words, that the uncertainty could not be removed until after the event, which of course is very difficult for the people who are feeling uncertain?

**Danny Alexander MP:** I think that I would say two things to this. First, the relevant Committees in the House of Commons are conducting investigations, one on defence and one on these issues, and the relevant Ministers from the Foreign Office and Ministry of Defence will be giving evidence in due course in those inquiries and setting out in detail that position. I would not particularly want to skate over it in an answer here, but I think that the European Commission would feel that it was able to give advice on matters of this kind to the SNP and its Catalanian equivalent, or do you feel that in these matters it would think that it ought to stay out until the votes had actually been taken—in other words, that the uncertainty could not be removed until after the event, which of course is very difficult for the people who are feeling uncertain?

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**Q521 Lord Forsyth of Drumlean:** Having failed to get you to come down clearly on whether the Bank of England would be a lender of last resort to an independent Scotland, perhaps I could attack the question from 180 degrees round. The proposal is that there should be an independent Scotland that would use the pound, would not have its own currency, and would therefore have no ability to print its own currency. It is rather like the situation with Ireland, which got into difficulty and to which we offered bilateral aid. You said that you would get away from a situation where you had to bail out the banks. Would an independent Scotland that got itself into difficulties be too big to fail from the point of view of the rest of the United Kingdom?

**Danny Alexander MP:** At the risk of disappointing you again, what you are highlighting is another very serious concern, but I shall answer the question the other way around. We took the decision as part of the European Union and part of the IMF that we would engage in relation to Ireland; we took that decision based on very specific circumstances at the time, so I am not sure that I can give you a blanket yes or no answer to a question that has a number of hypotheticals built into it. My central contention to this Committee is that the current arrangements, whereby Scotland is part of the longest standing fiscal, monetary, political and social union—and most successful such union—in world history, is better and
more secure for Scotland than any other set of arrangements, because there could certainly be no certainty that such support would be forthcoming. That would have to be a decision made according to the circumstances of the time, and no doubt by a future Government that had a whole range of other factors to deal with.

Lord Forsyth of Drumlean: If I may just press you on this, although I am not asking you to write a cheque now, this inquiry is looking into the consequences and implications of an independent Scotland for the rest of the United Kingdom. If I were a Treasury Minister, I would have asked my officials to look at what the consequences of an independent Scotland would be. I would ask, “If it got into difficulty, would it be too big to fail, what would we need to do, and what would the implications be for England?” The vote is only taking place in Scotland but I think people in England are entitled to know about the knock-on consequences here. Scotland and England are so integrated that if you had an independent Scotland and Alex Salmond went on a great spending spree—perish the thought—got into serious trouble and was unable to print money to tide him over, would we see the kind of arguments that we saw in respect of Ireland, that the rest of the United Kingdom is so dependent on its relationship with Scotland that we would have to intervene and bail them out? Can you help me to understand why that argument would not apply?

Danny Alexander MP: I am not necessarily saying that that argument would not apply.

Lord Forsyth of Drumlean: So you are saying that it would.

Danny Alexander MP: I do not yet know the answer to that question, because I have not considered it in the way that you suggest. We are in the early stages of our piece of work looking at all these issues, and this is no doubt one that is worthy of further consideration. I go back to the point that I made originally, which is that there is no certainty that those arrangements would be made in the same way as they were for Ireland. Equally, that risk does exist. I have not yet heard anything from the Scottish Government, who are advocating independence—I am advocating the continuation of the United Kingdom as it currently exists—that offers in any way a suggestion of how arrangements could be put in place.

Lord Forsyth of Drumlean: I ask the question because there are people in England—you may have come across one or two of them—who say, “Oh, if we got rid of Scotland, that would be fantastic. It would save us a whole load of money and we would be better off”. Fortunately, they are still in a minority, but there are such people. I ask the question, because it seems to me that the consequences of break-up of the United Kingdom on both sides of the border implies substantial difficulties both for Scotland and for England.

Danny Alexander MP: That is a very important point, but I would not start that argument with something as distant and hypothetical as the scenario that you have painted. I would start with the fact that Scotland is 10% of the UK economy; it has very important industries and sectors that lead the rest of the United Kingdom, where trade flows across the border amount to £45 billion a year. Something that you have been asking other witnesses about is what we have seen in the case of other unions, which has involved border effects, disrupting trade, and so on. I think that there are more immediate reasons why continuing the United Kingdom is important to businesses and individuals in England as well as to Scotland.

Q522 Lord Hollick: I think that exchanges with the Committee have shown that there are a number of areas of very significant uncertainty. You have referred several times to a great deal of work being done at the Treasury to look at these matters. Do you intend to publish this work, because the voter in Scotland would need to be able to know the answers to some of these questions—and of course voters in the United Kingdom who do not have
a say in this would also be interested to know the answers—before they cast their vote? Otherwise they are casting their vote effectively for a pig in a poke. In the absence of dialogue and negotiation, the decision around a referendum could be, “We would like independence but if you say that you would like independence too we will come back to you in a few years’ time when we have had all these negotiations”. That is not what the Prime Minister and the First Minister in Scotland have in mind—or if they do, they have not told us that. In the absence of a proper negotiation on what the divorce arrangements are going to be or publication of all the excellent work that the Treasury are no doubt doing, it is quite impossible for the electorate it have an informed view on this matter.

Danny Alexander MP: In answer to the first part of your question, yes, we will publish work. We have a very substantial work programme, looking at 13 or 14 different strands of argument to precisely furnish with information people in Scotland who have to make a decision and cast a vote in this referendum—and of course it will be of much wider interest. That information will help them to make a judgment about the benefits of the United Kingdom and the issues where there is risk or where uncertainty is caused by this proposition. What we will not do is to set out for the Scottish National Party the case for independence; that is for that party to make.

Q523 The Chairman: That was one of the questions that we were going to ask at the very end of this session, but let us deal with it now. Can you give us some idea of what exactly you will be publishing and what the timetable is, and so on? There is great interest in both Houses but also in the public at large as to when that will be.

Danny Alexander MP: I think we have published, but if we have not, the list of the areas that are being looked at. Some of them are areas of Treasury interest that we have discussed in this Committee, such as monetary policy, currency arrangements, fiscal arrangements, debt and so on. Others are areas where other departments are principally responsible—on European issues, and so forth. We will publish the results of that work stage by stage over time, between now and the referendum taking place. I hope what that will do is to provide a body of factual information and analysis that can help to support people in understanding the implications of what they are being asked to vote for. All the results of that work will be made public and published stage by stage, I would think probably starting in the New Year and then building from then.

The Chairman: It would be very helpful to us if you could give us a note, as far as you can at this stage, of the subjects that are being covered and when we can expect some of these papers to be published.

Sir Nicholas Macpherson: I think that the Secretary of State for Scotland answered a question in July setting out the individual strands, but we will be happy to come back to you with more detail.

Q524 Lord Lawson of Blaby: May I follow up what the Chairman has just said? What many of us think is required is something that goes a bit beyond that. Of course, there are many people in Scotland who say, “To hell with the economics, we want political independence—that’s it”. Nevertheless, there will be many others who feel that the economic issues are important. We have identified some of them in the questions that we have asked you so far, and there may be, or certainly are, others. What many people feel is that it would be a grave dereliction of duty if the Treasury were not to produce a single paper analysing and saying, “These are the economic issues”, first identifying them and then analysing them and then reaching conclusions strictly on the economic realities. It would
need to be a single paper, so that everybody can see what the economic issues are so they can cast their votes in the light of this. To put things out in dribs and drabs and in a “on the one hand, on the other hand” way is not good enough.

Danny Alexander MP: It is what we are going to do to start with. I will certainly consider your suggestion over the months to come. There is going to be a campaign in Scotland—and I accept your point that this will be of interest outside Scotland—with a group of people arguing the case for independence and a group arguing against. Where we see our role as being centrally important is in providing a body of facts and analysis, which as the Chairman pointed out at the start of the session, and which it is clear from your reasoning in establishing this inquiry in the first place, has been lacking in this debate. That is a very good and important role that the UK Government can engage in. As to whether some further publication should then be brought together, collecting that in some summary form, that is an interesting proposition that I will certainly take away.

Q525 Lord Tugendhat: There is a campaign in Scotland, and the Scottish people have a right to demand answers to those questions. I was very struck, reading the editorial in the Scotsman this morning and in the Daily Record by the attitude that they took to that. Obviously, you have a responsibility to provide information for the Scottish people to enable them to take a rational decision. But you are a Minister of the UK Government and Sir Nicholas is the head of a United Kingdom department. We in England do not have the vote in this referendum, but we have a right to information. Not only ought you to provide information to the Scottish people to enable them to make a rational decision, but you also have a duty to the English, Welsh and Northern Irish to provide information that would enable us to form a judgment as to the implications of the decision, even though we do not have a vote on it.

Danny Alexander MP: Certainly, even if we wished to, there is no way that we could provide information to the people of Scotland and keep it secret from everybody else. The information that we produce in terms of identifying issues and arguments, setting out the strengths and benefits of the United Kingdom, analysing the issues and challenging some of the assertions—in so far as any assertions are clearly made, which is quite rare at the moment, by the advocates of independence—will be available for everybody to look at. We have accepted as a Government that the people of Scotland have a right to make this decision for themselves in a referendum. It is a single-question referendum asking this question. Our principal responsibility is to make sure that the decision is taken on the basis of proper evidence and argument.

The Chairman: We now have a vote. We have about three other subjects that we wanted to cover, but we have covered the major ones. It might be better for all of us if we put those three questions to you in writing and published them with the transcript and the evidence. They are not the key ones—we have dealt with most of those. Would that be agreeable to all members of the Committee? I thank you very much. This has been an illuminating session that has covered most of the key issues. I think that there is an agreement between us that a lot more information is required for Scotland and the rest of the United Kingdom. It has been most helpful—you have been very open and have clearly stated your own view—and we will certainly use a lot of the information and the discussions that we have had today when we go to Edinburgh and Glasgow next week. So thank you for coming.

Danny Alexander MP: Thank you for the opportunity to give evidence.
TUESDAY 15 MAY 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Lawson of Blaby
Lord Levene of Portsoken
Baroness Kingsmill
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witness

Professor David Bell, Professor of Economics, Stirling University

Q1 The Chairman: Good afternoon and welcome to the Economic Affairs Committee of the House of Lords. This is the first hearing of our new inquiry into the economic implications for the United Kingdom of Scottish independence. I should say for the record that copies of Members’ entries in the Register of Interests are available in the Room.

As we start on this first day, I should like to say one or two points about the inquiry and why we have chosen this subject. The first point that I want to stress is that we are not taking a political line. We are impartial on the issue of whether or not Scotland should be independent, or something short of that. That is not the intention of this Committee. Nor will we be looking at any constitutional matters, because this is purely an Economic Affairs Committee, and we will be looking at economic implications. Why this subject? In any vote or referendum, if it ever comes, on Scottish independence, it is crucial that there should be a proper understanding of the implications. So far, in public debate, this has not been a particularly well trodden field. Hence, in our inquiry, we hope to illuminate—not eliminate—some of the issues and consequences, as a contribution to what needs to be a very well informed debate. We are going to start today with Professor Bell, who has many
Professor David Bell—Oral evidence (QQ 1-55)

qualifications for commenting on this subject. I hope that today will set the scene for the kind of issues that this Committee is going to be interested in in our inquiry.

Professor Bell, welcome. Thank you very much indeed for coming all the way from Stirling for today’s hearing. I should be grateful if you could speak loud and clear for the webcast and for the shorthand writer. Would you like to make an opening statement, or shall we go straight to questions?

Professor Bell: I am quite happy to go straight to questions.

Q2 The Chairman: Thank you very much. I start with the first question. There are of course very many economic implications today but, first, if Scotland becomes independent, some of the UK’s stock of public assets and liabilities would be divided. I should therefore like to ask: in your view, which assets and liabilities are the most important, from an economic perspective, for Scotland and the rest of the UK? What would be your guiding principles in making a division? Are there important items that should not be divided, and why?

Professor Bell: Let me start by saying that there are not, as far as one can tell, any rules or uniform practices in international law that establish any obligation on the part of a successor state to warrant the credit of the national debt of the predecessor state. However, there are only a relatively small number of cases that we can appeal to in this respect. One of the most recent is the Czech and Slovak case, where the division of the debt was based on population and, in the case of the assets, broadly made in terms of location. It is not an ideal comparator because at the time of the dissolution of Czechoslovakia the debt was only around $9.3 billion, so it did not amount to a great deal. In the end, the two successor states agreed to divide on the basis of population.

One argument is that put forward by one commentator in particular, Dane Rowlands, who said that it is important to think of equity in decisions around the division of debt. One category of player that is often omitted from the thinking around this is the creditors. The creditors would not want to support any division of the debt that would make it less likely that they would be repaid. So it would be in their interests to see that there was some equity in terms of the division of the debt. Typically, that has been a population-based approach—although, as I say, there are very few precedents.

Another possible method is the historical benefits approach, whereby one sort of takes all the net benefits, as far as one can record them, that Scotland may have accrued over the past, say, three decades, and argue that that net debt should be repaid. So you basically work out the fiscal deficit each year and sum up those fiscal deficits. That would be a historical benefits approach. One can do that and arrive at quite a large number. On the other hand, if the successor state inherited a large proportion of the oil revenues, on the other side there would be the accrued net benefit of those to the British state over, say, the past three decades. When you weigh these up, as I did this morning, it comes out as pretty much even. So the net fiscal deficit over the past 30 years in Scotland, an issue to which I am sure we will return, is about the same as the aggregated value of the geographical share of oil revenues.

Q3 Lord Forsyth of Drumlean: Does that take account of the bank bail-out, which is obviously very substantial?

Professor Bell: No, it does not take account of that. What I would say—and this may interest the Committee—is that the David Hume Institute has been doing some work on
the debt and has recently published an estimate of Scotland’s net debt, based largely around a population share. Depending on where one counts the UK debt—whether one takes it as the figure for 2011-12—it makes quite a large difference because we have accumulated quite a large amount of debt in the interim. However, what we are basically talking about is in the range between £64 billion and £83 billion of debt, based on a population share. The David Hume work, which has been done by Lesley Sutton, also did what the Treasury has done for the UK as a whole, and looks at the whole of government accounts. It looks at pension liabilities, PFI liabilities and, if one does that, one gets a considerably larger figure. However, that is largely in proportion to the liabilities that the UK as a whole is facing.

Q4 The Chairman: Would the pension and PFI liabilities be done on a population basis as well?

Professor Bell: They are broadly the same. I have done the calculation for the pension liabilities. First, Scotland has a slightly higher proportion of public sector workers. Secondly, they are paid slightly less than the average public sector worker in the UK as a whole. Thirdly, they tend to have a longer pension accrual. So it pretty much works out close to a population basis. It is not going to deviate very far from that, so if one takes these into account, one gets a very large number—

Q5 The Chairman: Can you put this into perspective?

Professor Bell: The latest estimate of Scottish annual GDP is £117 billion. That is the order of the total production in Scotland. On the assets, here one starts to get into problems, because many of the assets are geographically specific and are not as liquid as the debt is. For example—I am just going back to the issue of the whole of government accounts—there is £60.6 billion in the UK accounts set aside for the decommissioning of nuclear power stations, but five of the UK’s 18 nuclear power stations are in Scotland, so it is clear that a population share would underestimate the decommissioning costs as far as Scotland is concerned. Then there is a whole bunch of bodies, many of them public corporations, and it is not clear how one might divide them. They include Forest Enterprise, the Meteorological Office, the British Council and the BBC World Service. In Scotland, you have bodies such as Caledonian MacBrayne and Scottish Water and the housing revenue account, which is, effectively, council housing—as it used to be called. Clearly, there are a number of issues around the assets, so calculations based on a population share would, one might argue, be very rough. One would expect, therefore, that there would be long negotiations around the assets.

Q6 Lord Tugendhat: You said you felt that the creditors would, in a sense, be on the side of fairness, but I wonder whether that is so. It seems to me that the interests of the creditors would be that the largest possible proportion of their debt should be held by the strongest possible successor state. Whatever judgment they might form about the credit-worthiness of the rest of the UK on the one hand and Scotland on the other, I suspect that they would wish the debt to go with the one that they felt was strongest.

Professor Bell: Well, yes. It depends, I guess, on how one might interpret fairness here. But if that were the case, then the successor state would not be very happy if that were the remainder of the UK, and Scotland would be extremely pleased. The trouble is that the credit-worthiness of Scotland has not been tested.

Q7 Lord Tugendhat: I think that that issue is probably going to be confronted. I think that it is quite possible that creditors would wish to go with the strongest. If they did so,
they might wish to sell off or dispose of the stock of the weakest that they hold. I had not thought of this issue until you made your observation about fairness. It is that which I am questioning.

**Professor Bell:** Yes, well I go along with that. I come back to the point that it is not clear at all how one would assess the credit-worthiness of an independent Scotland. There is no credit history there.

**Q8 Lord Lawson of Blaby:** You indicated that there is no international law covering this and it is therefore just a haggle, but you also indicated that precedent might help. Of course, if Scotland were to become independent, it would not be the first time that a part of the United Kingdom had become independent. In 1932, the greater part of Ireland became independent. Of course, life was very much simpler in those days. The numbers were smaller and the reach of government was less. What happened then?

**Professor Bell:** I cannot remember. I am racking my brain.

**Lord Lawson of Blaby:** You have studied it, obviously.

**Professor Bell:** I have been looking at more recent occurrences. Ireland certainly stayed within the sterling area for a long time, but it would be remiss of me if I committed myself to saying exactly how the division of assets was made at that point. However, I would be happy to come back to you on that.

**The Chairman:** Perhaps you could let us know.

**Lord Lawson of Blaby:** I think it would be useful if the Committee were fully informed.

**Professor Bell:** Okay.

**Q9 Lord Shipley:** Perhaps I may ask a question about the Czech and Slovak republics, and the issue of assets. I think you said that the division of assets was by location. Was it actually as simple as that? For one thing, many of the industries were state controlled. Another issue was that as regards areas such as nuclear power—and power stations generally—it might have been difficult to divide the assets. Was it actually as simple as a division by location?

**Professor Bell:** As far as I know, it broadly was. I do not know the details of particularly difficult cases, but it did not take long for this allocation to happen. It may be that the assets were not worth all that much, given the situation.

**Q10 Lord Levene of Portsoken:** It seemed to me, certainly when I thought about this initially—you say that there a number of assets physically located in Scotland, so they should stay on that side of the line and the rest should stay on the other side of the line—that it then becomes a lot more complex because Scotland is part of the union. Therefore, if you look at the overall value of the assets in the United Kingdom, Scotland would obviously be entitled to a share, according to some formula. What happens? RBS has been mentioned. RBS has become more complex because it is no longer entirely a private company. The majority of it is state owned. Is RBS a Scottish business? And if it is, what do you do with those assets, the majority of which may well not be located in Scotland? It is a little bit like divorce, where you have a couple with two homes—one saying, “That home is mine, and the other home is yours”. What if there are five homes? I am scratching around to try and think of some formula that could apply to this issue.

**Professor Bell:** I was not necessarily arguing that everything north of the border would be counted as Scottish. There is no easy answer. This is a long and protracted negotiation.
Q11 Lord Forsyth of Drumlean: Just on that point on RBS, would an institution of the size of RBS be able to raise its capital within an independent Scotland? Would it be able to stay in Scotland? If it therefore had to move, what would then happen to the liabilities?

Professor Bell: It would depend, to a large extent, on financial regulation—which is a point that we will come to. Clearly, if an independent Scotland was being asked to be lender of last resort to a massive operation such as RBS, that would not be feasible and there would therefore have to be negotiation about how it split its assets geographically.

The Chairman: We move on to the next subject.

Q12 Lord Lawson of Blaby: This, I assume, is a less complicated matter. There are, at the moment, transfers that occur at the official level between the rest of the United Kingdom and Scotland—partly through having the same social security system, and partly the Barnett formula, which does not cover social security. I take it that if there were to be Scottish independence, all these transfers would automatically come to an end, because there is clearly no case of which I am aware of transfers continuing on that basis between two wholly independent sovereign states. Do you agree?

Professor Bell: Yes. The Barnett formula would come to an end, and so the system for geographical distribution of government expenditure within the UK would cease to exist. Some new formula would have to be found that covered England, Wales and Northern Ireland. As far as Scotland is concerned, that would end, which would leave it with a number of new spending commitments—principally on social security—and with some new revenue streams to which it has not had direct access, although it has had indirect access to them in the past.

Lord Lawson of Blaby: The same would presumably apply to other aspects of public expenditure—for example, to pensions and social security. Presumably the present system in the United Kingdom would continue for what remained of the United Kingdom, but it would be entirely a matter for Scotland to decide what level of public pensions to pay and what the level of social security provision there should be.

Professor Bell: Again, there would be an interesting debate to be had around that. In terms of public expenditure flows, what Scotland gets through the Barnett formula is largely the departmental expenditure limit—the DEL—covering health, transport, housing and so on. The net amount required to keep pensions in balance comes through annually managed expenditure from the Treasury that is therefore managed on a year-to-year basis. Many of the pensions are pay-as-you-go pensions, and that therefore covers most of the public sector other than local government. Exactly how the division would take place would be of interest. I presume, with pay-as-you-go pensions, the Scottish Government would have to take that role of supplying what was effectively AME to make up whatever shortfall there happened to be—which is the difference between people’s contributions and the net pension payouts.

Q13 Lord Forsyth of Drumlean: What is your estimate of that? You described how the Barnett formula would disappear. I think that you have done some work that suggests that, if Scotland were to be funded on a needs basis rather than a Barnett basis, the gap would be of the order of £4.5 billion. Is that right?

Professor Bell: Well, it depends. There are very many ways to consider needs. One very simple way is to look at something such as the share of aggregate social security payments. If Scotland got its share of aggregate social security payments as a mechanism for determining its transfer from the UK Government, it would certainly receive less than it does now. The
Barnett formula was intended to narrow the gap between spending per head in Scotland and the rest of the UK, but it has moved at a glacial pace.

**Lord Forsyth of Drumlean:** We do not want to get into Barnett, because we have considered that before. I do not want to put words into your mouth, but I thought that your work indicated that Scotland benefited to a considerable extent, to the order of £4 billion or so.

**Professor Bell:** At the time I did the calculation, that was the number that I came up with.

**Q14 Lord Forsyth of Drumlean:** On Lord Lawson’s question, in aggregate, what is your estimate of the likely net financial position, following the loss of Barnett and the other revenue streams? Will Scotland be worse off and, if so, to what extent? Or is it going to be better off?

**Professor Bell:** I think my approach to this would be to follow the Government Expenditure & Revenue Scotland approach, which is to ignore Barnett and look at the expenditure in Scotland, on the one hand, and, on the other, the revenues associated with the population and the current corporate structure of Scotland, and the geographic share of North Sea oil, which amounts to around 90% of the total. In those circumstances, if you exclude North Sea oil revenue, the Scottish Government’s estimate of the fiscal deficit in Scotland in 2009-10 was 17.9%, which makes the figure extremely high. However, if you take in the geographic share of North Sea oil, it comes down considerably, but is still far too high—given, let us say, the Maastricht criteria—and remains in double digits at 11%. Nevertheless, the figure is not a million miles away from the overall UK figure. Remember that the UK has had a historically high fiscal deficit in the past two or three years.

**Lord Forsyth of Drumlean:** Was that 11% of GDP?

**Professor Bell:** Yes.

**Lord Forsyth of Drumlean:** Is that Scottish GDP?

**Professor Bell:** That is Scottish GDP.

**Lord Forsyth of Drumlean:** Is that about £13 billion?

**Professor Bell:** It is £14 billion.

**Q15 Lord Lipsey:** Is there not a more serious problem lurking behind that, which is that the oil revenues, by the nature of the physical thing upon which they are based, are going to go down, but expenditure on some of the things on which Scotland has decided to spend a lot of money—such as free tuition, free prescription charges and, above all, free care—are rising rather rapidly? Therefore, whatever the gap may be, when the break comes it is likely to get a great deal higher as time goes by.

**Professor Bell:** All Governments are certainly facing issues of fiscal sustainability in particular, mainly driven, I think, by demography. Scotland would be no exception. There would be the additional factor of the oil, and undoubtedly the production of both oil and gas has been falling. There has been a compensation in so far as the price has been rising, but oil prices are pretty difficult to predict. If they go higher and stay very high, there will be more exploration effort, which may extend the lives of existing fields or, indeed, even bring new fields into production. However, the recent trend has been for a downturn in production.

**Q16 Lord Lawson of Blaby:** There are two dimensions to this: the likely trend of North Sea oil and gas revenues, which is what Lord Lipsey was talking about, and the volatility issue.
They are not very reliable or predictable sources of revenue, which creates the vulnerability. We see this even in the case of a much larger economy such as Russia.

**Professor Bell:** Certainly, it would be wise for the Scottish Government to try to hedge against that volatility. Obviously, we would pay some price in doing so. If one takes £7 billion as the latest estimate of North Sea oil’s share of total Scottish government revenue of £50 billion, and if that £7 billion is subject to considerable volatility, then longer term planning for public services becomes pretty fraught. I imagine that one would try to find ways of smoothing the income stream.

**Q17 Lord Levene of Portsoken:** I am just trying to get my mind around the complexities of this. If you look at this in terms of, say, defence expenditure, you could say that there is disproportionate defence expenditure in Scotland because of the facilities there, which outweighs what you would normally expect in terms of the population split. It occurs to me that as a result of that, Scotland gets a lot of income from that expenditure in terms of jobs and construction facilities. It is going to be a very complex equation to work out, is it not?

**Professor Bell:** I am not actually sure that Scotland has a disproportionate share of all the military establishments. It certainly has a lot of the capital assets, particularly those associated with the nuclear site at Faslane. Defence itself is a big economic issue, partly because when I described Scotland’s net deficit, the underlying assumption was that Scotland pays in its share per head towards the UK total defence spend. It might be the case that the Scottish Government took a different view about how much to allocate to defence spending, and perhaps went for the Irish model or some different model. It is an area worthy of investigation on its own. However, as far as the assets are concerned, that defence policy will partly determine how they might be reallocated post independence—which is a hugely complex matter.

**Q18 Lord Levene of Portsoken:** Then it is going to become more complicated, because I was thinking the matter through on the basis that the facilities that are there will stay there. If the Scottish Government said, “Look, we do not want to spend all this money on nuclear deterrence. As far as we’re concerned, you can reduce that by two thirds”, then the rest of the UK, if its Government decided that they wanted to keep those facilities in being, would have to say, “Do we want to have them in Scotland? Do we want to have them at all? And if Scotland does not want them, are we going to have to replicate them somewhere else, or are we going to have to effectively buy them from Scotland?” There is an added complexity to this issue as you go through it.

**Professor Bell:** That also applies in terms of construction of things such as aircraft carriers. Where would a future rest of the UK Government wish to place its defence orders? That is obviously an interesting question.

**Q19 Lord Forsyth of Drumlean:** It is a particularly easy one to answer. Can I ask you about currency? If Scotland becomes independent and, presumably, applies for membership of the European Union, which currency would you expect it to use?

**Professor Bell:** My opinion would be that sterling would be the obvious currency to opt for. I can give you some reasons. The traditional economic theory is called the theory of optimal currency area. An optimal currency area should have good labour mobility across the territories involved. There is clearly pretty high labour mobility—there is much higher labour mobility between Scotland and England than there is, for example, between Ireland and England. There is clearly a uniform capital market across the UK, so there is pretty clear
capital mobility. There is also wage and price flexibility because both the UK as a whole and Scotland in particular have fairly flexible labour markets. It is also the case that Scotland and the rest of the UK share pretty similar business cycles. Maybe in the 1980s they did not, but there was particular improvement in the early 1990s in Scotland’s unemployment rate, relative to the UK as a whole. Since that point in time, it has been pretty difficult to show any significant difference in the business cycles. That means that you are not in the situation of, say, Ireland and Germany five years ago, when the Irish economy was booming and the German economy was pretty much in the doldrums. Therefore, the difficulty comes in defining an appropriate monetary policy that suits both areas. That would be less difficult because of the synchronicity of the business cycles between Scotland and England. The fifth condition is the one that is causing all the difficulty within Europe, and I suspect that you would want to return to—fiscal transfer mechanisms. What we have established, at least in the past few minutes, is that the fiscal transfer mechanisms, in the shape of the Barnett formula, would not be there.

Q20 Lord Lawson of Blaby: You are obviously right to say that a common currency between England and Scotland makes a great deal more sense than joining a single currency within the eurozone. That is absolutely clear. Nevertheless, however sensible it is, the precedents do not go that way, do they? Even when Ireland became independent, it replaced the pound with the punt. More recently, when the Soviet Union broke up, all the component countries decided that they wanted their own currencies. That may be highly sub-optimal, but that is what happens. Have you looked into that?

Professor Bell: Yes, in a sense, but only to establish that that is entirely sub-optimal. It is sub-optimal for England as well, because it has about £40 billion-worth of trade into Scotland. Having a transactions cost when changing currency at Berwick is, I suspect, not in the interests of English businesses, and it is clearly not in the interests of Scotland.

Lord Lawson of Blaby: It is a much bigger proportion of trade for Scotland than it is for the United Kingdom.

Professor Bell: That is true.

Q21 Lord Forsyth of Drumlean: Is there not a difficulty here in that, in order to join the European Union, it would be necessary for a new member to apply to embrace the euro?

Professor Bell: It would be necessary under the current rules to embrace the growth and stability pact or its now stronger version—the recent treaty agreed towards the end of last year—which pretty much seems to suggest that fiscal balance is almost a requirement for being a member of the eurozone per se.

Lord Lawson of Blaby: Lord Forsyth is right. Any country joining the European Union is obliged to move to the euro. However, there is no time limit and, therefore, although in theory they would have to do it, they could keep putting it off. That is my understanding of the legal position.

Professor Bell: Yes, that is true. I think that Sweden is in that position, as is the Czech Republic.

Lord Lawson of Blaby: The Czech Republic certainly is.

Professor Bell: Yes, the Czechs have just deferred in a kind of European way, I guess.
Q22 Lord Forsyth of Drumlean: Can you tell us what you think the implications might be for the rest of the United Kingdom of Scotland continuing in sterling, perhaps with a longer term view to switching to the euro?

Professor Bell: For the rest of the United Kingdom, if Scotland stayed with the pound, there would be little disruption of trade flows.

Q23 Lord Forsyth of Drumlean: Would we not be in a situation where the rest of the United Kingdom would have a state on its borders, rather like Greece is today, which was not actually in control of interest rates and other matters? Is there not an issue arising from that about being too big to fail?

Professor Bell: If Scotland, presumably following negotiation, stayed with sterling, it would effectively be accepting the Bank of England's monetary policy. So the capital markets would presumably continue to operate in a free way across the UK as a whole.

Q24 Baroness Kingsmill: In those circumstances, would Scotland be subject to the same financial regulation?

Professor Bell: That is a big point, which is an issue that perhaps needs to be considered quite urgently. The issue of financial regulation is important because there are many life insurance and pension companies in Scotland that are currently selling policies. They cannot be entirely sure of the regulatory regime that they will be under when those policies mature. Therefore, some clarity around the issue of financial regulation is an urgent issue that should be addressed well before the referendum.

Q25 Lord Forsyth of Drumlean: Before we leave this important point, can I just return to the monetary position of an independent Scotland using sterling? You quite rightly said—we talked about this earlier—that Scotland might find it difficult to meet the Maastricht criteria. It would clearly have to be bound by the Bank of England's criteria. Would that not actually mean that, given the numbers and depending on the oil price, there could actually be a requirement to squeeze public expenditure in Scotland as a result of fiscal policies that are being pursued in England?

Professor Bell: It would seem to me that that part of the deal would have to involve a discussion of fiscal policy. If Scotland wants to adopt the pound—

Lord Forsyth of Drumlean: The Bank of England would call the shots.

Professor Bell: There would have to be a pretty serious discussion around that. I think that the Government of the rest of the UK would have to be involved, because fiscal policy is not really the remit of the Bank of England, but clearly—

Lord Forsyth of Drumlean: Indeed, it is not. So that is not really independence then, is it?

Professor Bell: In terms of fiscal independence, it would be limited.

Q26 Lord Lawson of Blaby: Further to Baroness Kingsmill's point, obviously one is only guessing here but, given that the European Union is currently trying to set down rules on bank regulation—which we in this country are currently resisting because we want higher standards and because we are in favour of ring-fencing, which is not the practice in the rest of Europe—presumably an independent Scotland would say, “We will accept the European Union rules”, so there would be a difference between what happened in Scotland and what happened in the rest of the United Kingdom. What would be the consequences of that?
**Professor Bell:** I think that the Scottish Government would need to be pragmatic and consider where their largest markets are. If they took the view that Scotland’s most important market was the rest of the United Kingdom, they would need a set of financial regulations that were very close to those for the rest of the UK. Clearly, there would be potential difficulties if regulation was looser in Scotland relative to the rest of the UK, because that might set up behaviours among banks that might be deemed to be threatening.

**Baroness Kingsmill:** Threatening to whom?

**Professor Bell:** Threatening to overall financial stability.

**Q27 Lord Levene of Portsoken:** We have talked about the central bank and the regulator, but what about tax? Would you expect an independent Scotland to introduce its own rates of corporation tax and personal income tax, which could be different from those for the rest of the UK? If that happened, what would be the likely economic effects on the rest of the UK and on Scotland?

**Professor Bell:** Scotland will very shortly have the ability to change its income tax rate, even without independence, relative to that of the rest of the UK, but it has actually had that since devolution in the form of the 3p variation possibility on the basic rate. That facility has not been used, so it will be interesting to see what happens once the Scotland Bill comes into force.

On corporation tax, I suspect that that might be part of the negotiation that we have just been referring to, given the relationship between monetary and fiscal policy. Clearly, if one takes the Irish example, corporation tax has played an important role in the success of the Irish economy over the past couple of decades. That advantage is now widely resented. However, if I may digress slightly, it is wrong to view the success of the Irish economy as being based purely on having a corporation tax advantage. Between 1997 and 2008, Ireland had a 50% increase in employment—absolutely massive—and a lot of that was to do with more women coming into the labour force and large-scale immigration. It is not obvious that those avenues would be open to an independent Scotland. I suspect that the effect of a change in corporation tax might be less apparently dramatic than has been the case in Ireland.

Clearly, the issue of corporation tax is up in the air at the moment. The United States is getting extremely exercised by the fact that large numbers of its corporations hold huge amounts of cash overseas and it has targeted a number of what it deems tax havens, including Ireland, as it seeks ways to extract more tax from these corporations. That would be an argument to suggest that the seeming tax advantage that Ireland currently enjoys may not last into the longer term. If Scotland were to cut corporation tax, there would have to be some increase in taxation elsewhere or some reduction in spending from the Scottish budget—unless one believes the Laffer curve interpretation that cutting tax rates will increase revenue.

**Q28 Lord Levene of Portsoken:** An additional point that I was going to ask about is VAT, which was recently an issue in the Channel Islands where there is either no VAT or much less VAT. Companies were diverting their business there so that they could get a greater share of the cake. If there was a different VAT rate in Scotland, people buying things online would not really care where the company was located and, because it would be all part of the same operation, there would be no duty between the two Governments. How would you sort that out? Would you get into a sort of downwards tax war spiral between the two as to who would get the biggest share of the cake by charging less VAT?
Professor Bell: I do not think that it would be in the interests of either state to have tax competition or a race to the bottom on tax rates. One might well wish to have tax rates that are as low as possible, but a race to the bottom is not—

Q29 Baroness Kingsmill: It would not be difficult for corporations to move their headquarters up to Scotland if there was a differential tax rate. That is what they did in Southern Ireland. Lots of companies that would not otherwise have situated their headquarters there did so because the corporation tax was so low. That is exactly what would happen in Scotland, is it not?

Professor Bell: It is quite possible, but you would need to work out what the net benefit of that might be to the Scottish economy.

Q30 Lord Lawson of Blaby: It would be a funny kind of independence if you did not have different tax rates. If you have the same tax rates but simply forgo the ability to vote in elections where tax rates may be an issue, that is a very odd state of affairs. There are bound to be different tax rates. Otherwise, it is a nonsense.

Professor Bell: I suspect that there would be. You might take the view that, for example, income tax rates would go up. A huge amount depends on the reaction of corporations and individuals to tax differentials in what is quite a uniform and flexible market. At what point does it become in a corporation’s interest to move from London up to Edinburgh? What kind of corporation tax differential would encourage that move? Similarly, on the upper rate of income tax—the upper rate is what really matters, because the top 10% of earners supply something like 40% of income tax revenues—at what point do differentials in income tax rates cause a significant movement or apparent movement, which might be feasible depending on how strictly the tax rules are set, between Scotland and England?

Q31 Lord Forsyth of Drumlean: A 1% increase in income tax across the board in Scotland yields about £480 million. In your earlier answers, we were talking about a deficit of £14 billion, so why are we talking about taxes being reduced at all? Surely if corporation tax is going to do anything, it is going to go up rather than down.

Professor Bell: One would have to make adjustments elsewhere, clearly. Remember that the £14 billion excluded the effects of oil. With the oil, it was £7 billion, but nevertheless that is a significant deficit.

Q32 Lord Tugendhat: Can I approach the issue from the other end? We have been talking about the degree of freedom of action that an independent Scotland would have in setting different tax rates, but surely one of the objects of being independent is to have a different set of criteria for the expenditure policies. Indeed, I understand that one point made by the SNP is that an independent Scotland would have different priorities from the rest of the UK. If you are going to have different priorities, it follows that you must have different tax rates. Therefore, the question that we have to explore is not just the extent to which tax rates can vary but the extent to which it is possible for an independent Scotland to have different priorities from the rest of the United Kingdom without having different tax rates. Both sides of the equation need to be considered. The inference from what you are saying is that the scope for an independent Scotland to have different priorities from the rest of the UK is actually rather limited. That is what I understood you to be saying.

Professor Bell: On the spending side, for a long time there have been powers to vary the composition of spending and, indeed, the organisation of spending within broad headings. For example, health spending in Scotland is now about 10% per head more than in the rest of
the UK as a whole, which is a much smaller margin than it used to be, but the organisation has remained much more stable, let us say, than has been the case in the rest of the UK. There are already quite a lot of opportunities to vary spending and there are interesting aspects to that, such as the terms and conditions of people working in the public services. For example, health sector pay in Scotland amounts to £6 billion, which is a considerable amount, but that is to a large extent determined by UK-wide negotiation. Post independence, even though one might have possibly different spending priorities, how would one arrange the remuneration of public sector workers? Presumably, one would have to split away from the public sector arrangements that currently exist for the UK as a whole. Another issue is whether you use slightly less generous working conditions and remuneration in Scotland as a way of finding some movement in the budget.

Q33 Lord Shipley: To your knowledge, has any work been done on the economic impact of differential taxation? We have talked about corporation tax and the potential for cross-border movement because of differential VAT rates, which could apply not just to internet purchase from the Channel Islands, but there are many different kinds of personal tax in addition to income tax, such as capital gains tax and inheritance tax. Another issue, which I think will be the subject of debate in the Finance Bill in the House of Commons, is that of differential rates in air passenger duty. In terms of our inquiry, has anybody done any work on the impact of differential tax rates in all those categories and others?

Professor Bell: I will certainly look for some examples, but there are not many that I know of. The general principles were set out by the IFS investigation into the tax system last year, which basically said that the more mobile a factor is the less you should tax it and the more static something is the more you should tax it. For example, since housing is largely immobile, housing and property is an area on which one might focus taxation, but on something like corporation tax companies may be very sensitive to the rate of tax. What I think the debate needs is probably more specifics rather than these generalities. I would be happy to look into those specifics.

Q34 Lord Lawson of Blaby: You mentioned the David Hume Institute. Has that done work on this?

Professor Bell: No, not as far as I know. I have been working with the David Hume Institute on a monograph that will appear in the next week or two on public sector remuneration in Scotland, which covers the pensions issue as well. On sensitivity to tax, the experts in the UK are the Institute for Fiscal Studies. For specifics such as differences within the UK, since there is no precedent it is pretty difficult to come up with estimates in which one would have a huge amount of confidence.

The Chairman: If you would like to give a note in response to Lord Shipley’s question, we would be very grateful for that.

Do we have any other questions on tax matters?

Q35 Lord Rowe-Beddoe: Good afternoon. Could you give a quick answer—if there is a quick answer—as to why the Scottish Government did not use the income tax variation powers that have been available since the original devolution settlement?

Professor Bell: I have no easy answer to that. There is an issue as to whether the Revenue was ever prepared to implement the 3p change in income tax, but the various Governments that have been in power in Scotland, which have come from a number of political constellations, have not sought to change the income tax rate.
Q36 Lord Lawson of Blaby: Lord Rowe-Beddoe asks a good question, but is the answer to it not pretty obvious? Taxation—I have some experience of this—is not a very popular activity. Therefore, they wish the unpopularity to go to the United Kingdom Treasury and they do not want any unpopularity themselves, so they do not want to touch it. Is that not the reason?

Professor Bell: That might be true.

Q37 The Chairman: Can I just bring you back to financial regulation, which we touched on quite briefly a moment ago? I would like to be clear about what you regard as the position of the Scottish financial institutions. Are they seeking a single financial regulator for both Scotland and the rest of the UK? If that does not happen, what would be the reaction of the Scottish financial institutions?

Professor Bell: I cannot really speak for them, but my opinion is that, given the current structure of their business, they would find having a single financial regulator an easier proposition than having an unknown, new regulator. As I understand it, the existing regulation is pretty onerous as it is and incurs significant costs, so presumably they would not wish to incur another set of costs.

Q38 Baroness Kingsmill: How do you think the markets would respond to, for example, Scotland issuing its own debt? Would there be cross-border effects? How would that go? Where would the risk lie?

Professor Bell: That is a pretty difficult question to answer, given the lack of history—

Baroness Kingsmill: It is as difficult as some of the other questions today, which you have coped with manfully.

Professor Bell: I would guess that the current UK rate of interest for, say, 10-year bonds, which is now around 2%, would be absolutely the lower limit, but there has to be a risk premium associated with the new borrowing.

Q39 Baroness Kingsmill: Might it depend on the separation settlement and on who got what?

Professor Bell: Exactly. The markets would take a view on the ability to repay. Within currency unions in the past week—we do not need to go through the examples—we have seen huge variations in the risk premium associated with, say, Germany on the one hand and Spain or Italy or Greece on the other. Clearly, the markets would take a view on how the new Scottish Government would repay the debt that it inherited.

An important aspect of that would be how it managed the debt. The UK has quite a slick operation in the Debt Management Office. Whether Scotland would set up its equivalent to that, I do not know—

Baroness Kingsmill: It would probably outsource it.

Professor Bell: That is a possibility with a number of these issues, which could just be outsourced.

Q40 Baroness Kingsmill: Would you like to hazard a guess about how things would work if it was the UK that went into crisis?

Professor Bell: That would be an interesting question.
Baroness Kingsmill: Many of these questions are highly speculative so I quite understand your difficulty in answering them, but it is the sort of thing that we are going to have to wrestle with a bit.

Professor Bell: Clearly, if the rest of the UK was in crisis, the pressure would be to have some form of devaluation relative to Scotland. That could be achieved by seeking some form of wage and price flexibility or dropping out of the monetary union—an interesting possibility, which I must admit I had not considered.

Q41 Lord Rowe-Beddoe: You talked about the dependence or otherwise on oil revenues. Clearly, for an independent Scotland the oil revenue is unlikely to increase. I think that the First Minister has mentioned that, with that oil revenue, Scotland should set up a sovereign fund along the lines of those in Norway or the Middle East and so on. Could that mitigate the possible adverse effects of such overdependence?

Professor Bell: In principle, I think that a sovereign wealth fund associated with a natural asset that is depleting is an appropriate way to go, because it means that the benefits of that depleting asset are acquired not simply by the current generation. Whether there would be the fiscal scope to go in that direction would be, under the current scenario, a difficult one to go down.

Lord Rowe-Beddoe: It is a bit late in the day to start one, I suppose, compared to Norway or some of these states in the Gulf.

Professor Bell: Relative to the overall amount of revenue that the GERS exercise implies for Scotland in 2010, the oil revenues are worth about one-seventh. There was a time in the 1980s when the oil revenue would have accounted for more than half of Scotland’s total revenue.

Q42 Lord Tugendhat: Rather than a sovereign wealth fund, it seems to me that in a few years’ time—it will not be this year—an independent Scotland would need to be thinking of a decommissioning fund. If we are saying that 90% of the oil will belong to Scotland, which may or may not turn out to be the case, depending on the life of the fields, which in turn depends somewhat on the price of oil, the whole question of decommissioning will loom. It would be a difficult negotiating hand for the Scots to claim that they should have as much as possible of the oil revenue but not have a comparable share of the decommissioning. The decommissioning aspect will enter into this whole equation.

Professor Bell: I think that it would. The question is: what is that share?

Q43 Lord Lawson of Blaby: Are you sure that it would? Is there not a case for saying that the decommissioning costs will fall on the oil companies that operate the fields?

Professor Bell: Presumably, they would get a tax allowance for the decommissioning. The direct cost would fall on the oil companies, but the tax allowance would mean that the revenues would be reduced.

Lord Lawson of Blaby: This is one of the ways in which the likely tax revenue looking ahead—this was #Lord Lipsey’s point—is liable to be on a declining path. There will be more decommissioning and less growth of oil production.

Professor Bell: I guess that is the way that it looks at present.

Q44 Lord Lipsey: At the moment, Scotland seems to have a trade deficit with RUK of about 10% of GDP. Assuming that there will be a single currency for the two bits after
independence, Scotland will not have the possibility of devaluing and hoping to make up the deficit in that way. How do you think the counter-flows would come about? Will there be greater labour market flexibility—downward pressure on real wages in Scotland—or is it likely that there will be counterbalancing capital flows of investment into Scotland? What kind of capital flows would those be?

**Professor Bell:** I had a look at the deficit figures. It appears that Scotland broadly has no deficit with respect to the rest of the world but a net deficit in respect of goods with the rest of the UK. I am not clear whether that includes oil production, which would put quite a different light on the deficit position. I think that the deficit was around £11 billion, and oil would contribute around £24 billion to Scotland’s GDP. Therefore, I am not entirely sure how that would work. I am not completely clear whether the deficit is in one direction or the other, but if we suppose that it was, you would then have capital flows out of Scotland and an adjustment would have to be made. I have argued that we have an optimal currency area and that we have wage and price flexibility, so one would expect relative real wages to be adjusted. That is one possible way of making the adjustment.

**Q45 Lord Lipsey:** That in itself could have big implications. I think that I am right in saying that, in terms of trade unions, Scotland’s unionisation rate is slightly higher than that of the rest of the United Kingdom. There might have to be changes in that sort of area to make those sorts of adjustments possible.

**Professor Bell:** The differences in our union membership rates are now pretty much at the margin. In the private sector, union membership in Scotland is not high. In the public sector, as in the rest of the UK, there is a higher level of trade union membership. I think that on both sides of the border, the recession has resulted in greater wage flexibility than we have seen historically in recessions.

**Q46 Lord Shipley:** Can I just pursue the issue of wage flexibility, mobility of labour and so on in the context of levels of employment and unemployment? Given that the Barnett formula will disappear with independence, what are the implications of that for employment and unemployment levels? Has any work been done on that? Presumably, employment levels would go down.

**Professor Bell:** In the first instance, let me say something generally about employment and unemployment levels. There is far greater variation in employment rates across the regions of England than there is between Scotland and the rest of the UK. Scotland has been very close to the rest of the UK’s performance in terms of the labour market for the last decade. Clearly, there are some variations within Scotland itself, but overall there is not that much variation between Scotland and the rest of the UK. If you take some demand out of the economy, the question is—this is a question often asked at the moment—does the private sector expand to fill that gap? In the short term, I guess that the answer would probably be no, and there would be some adverse effects on employment and unemployment. However, as far as I know, there has not been any work specifically associated with that.

**Q47 Lord Smith of Clifton:** My question is really about innovation and entrepreneurship. We know that in the 19th century Scotland’s engineering tradition and all that sort of thing was probably ahead of the rest of the UK. Is there any evidence of difference now in innovation and entrepreneurship? Much is made of the suggestion that an independent Scotland would unleash new creative talents in the country. How far do you go along with that?
Professor David Bell: Well, it could improve. If you compare the UK as a whole with Scandinavia in terms of the amount of money being spent on research and development, it compares poorly. For example, Sweden spends 2.7% of GDP on research and development, whereas the UK spends 1%. Scotland performs poorly within the UK, at around 0.5% of GDP being spent on research and development. In the public sector, there is quite a lot of research and development because the universities are quite strong, but in the private sector, which is what I am talking about, research and development is quite weak. For example, the best performing area in the UK is the eastern region—the Cambridge area—where around 3.5% of gross value added is spent on research and development.

I guess that the question is: how does an independent Scotland encourage an improvement in that relatively poor performance? Lots of things have been tried at the edges of fiscal policy with R&D tax credits and so on, but it seems to me that for Scotland success in terms of increased growth relative to the rest of the UK, or indeed the rest of Europe, would partly hinge on improvement in that kind of area. Without that, Scotland would need to fall back on the products in which it has a straightforward comparative advantage, such as the production of food and energy and so on, but if it wants to be at the high-tech end of production it needs either to be very productive with the spending that it incurs or to spend more.

Q48 Baroness Kingsmill: Could this not be a case of psychology rather more than economics? When they no longer feel like an oppressed nation, they might feel that they might become more innovative.

Professor Bell: I am not sure that I would go along with that.

Lord Smith of Clifton: That was a political broadcast on behalf of the SNP.

Professor Bell: There are successful hubs in Dundee and Edinburgh in areas such as biotechnology and so on, and Scotland just needs more of those. I do not think that the issue of oppression or otherwise hugely affects that.

Q49 Lord Smith of Clifton: Could I raise another question? We were always brought up in my youth to believe that the social capital in Scotland was much better because the schooling was very much better than in the rest of the UK. Of course, one of the reasons for the Celtic tiger in the Republic of Ireland was that it had a very highly qualified labour force, which could take advantage of inward investment and all the other things that came from lower corporate tax. Would you share my impression at the moment that primary and secondary education has fallen from the heights that it once had and, therefore, the social capital available in Scotland is not as good as it was?

Professor Bell: I think that the whole of the UK has slipped a bit in educational attainment. For example, in the OECD’s PISA scores, which compare pupils’ attainment at ages 11 and 14, both Scotland and England have been slipping down the rankings. Scotland is typically above England but both have been slipping down the international rankings, which is clearly not a good sign when capital is extremely mobile and firms seek out the best people as a reason to locate in whatever part of the world.

Q50 Lord Tugendhat: When The Economist wrote that article that attracted a good deal of attention, I read a riposte to it from Scotland—I cannot remember in which newspaper—which made the point that The Economist had taken no account of the forces of energy and innovation and what have you that would be unleashed by independence. Of course, for that matter, it did not take account of the forces that might be unleashed in England and Wales.
and Northern Ireland either. When you look at this prospective future, is there any reason that would lead one to believe that Scottish independence would affect the underlying growth rate of the Scottish economy vis-à-vis the rest of the UK, or vice versa? I am putting the question in a totally neutral fashion. Do you feel that there are forces that could be unleashed on either side of the border, or do you think that there are other factors, such as savings rates and that sort of thing, that could lead to differential growth rates?

**Professor Bell:** I will make a number of points. First, it is quite interesting to look at the OECD rankings of countries by per capita income. The most recent shows that the Czech Republic and the Slovak Republic, a couple of decades after they parted company, are beside each other—placed 25th and 26th—in the international rankings, so they have not managed to split apart very far. I would say that there is very little evidence that is going to help us answer your question. Some of it comes down partly to the small country/large country question: does a small country have shorter lines of communication that allow it to be a bit more nimble? For example, when the Chilean salmon stock was afflicted by some dreadful disease a couple of years ago, the Scottish Government got all the salmon producers together to see how they could take advantage of this—and they did. That is the sort of thing that can happen. The First Minister is across in Norway at the moment investigating the possibility of energy links with Norway. There are some things that you can do as a small country that may be more difficult for a large country, but whether those are enough to turn around the whole ship is a question that one can only speculate on. Clearly, there are examples of successful small countries, and there are examples of pretty unsuccessful ones as well.

**Q51 Lord Tugendhat:** There is one issue that I feel ought to have been raised earlier, but I missed the opportunity. I have always understood that the level of home ownership, and therefore of household debt, is very different in Scotland as compared with the rest of the UK. In the rest of the UK, home ownership is higher because in Scotland public housing took up a much greater proportion. This is the sort of question that Lord Best would have asked if he was still with us, but I wonder to what extent that is a factor that we should think of.

**Professor Bell:** It is quite important. The difference in home ownership rates has declined because there has been a lot of exercise of the right to buy within Scotland, but it is also true that house prices are lower and incomes are not proportionately lower, so you might say that household debt as a proportion of overall debt is lower in Scotland than in England. Having said that, I think that other forms of debt are higher—I may need to check on that—so there is a bit of swings and roundabouts as far as that is concerned. I doubt that this is of a sufficient margin that one might expect it to be a driver of differential performance.

**Q52 Lord Forsyth of Drumlean:** Listening to your evidence has been absolutely fascinating, but it is not obvious that there is some overwhelming advantage in independence or that there is a lot of room for manoeuvre. Have you made any estimate of what the cost of doing this might be? What would be the cost of unscrambling all this and sorting it out, and what impact might that have on the UK economy?

**Professor Bell:** I have not made a direct estimate of the numbers involved—

**Lord Forsyth of Drumlean:** Are you tempted to have a go?

**Professor Bell:** Possibly. I do think that the time involved would be considerable, and that would not be good for either party, particularly for Scotland, because it would increase uncertainty. All of the players—the stakeholders, so to speak—would be inclined to increase their risk premium the longer that the uncertainty dragged out.
Q53 The Chairman: When you say increase the risk premium, does that mean that for ordinary people their mortgages would go up?

Professor Bell: Yes, in effect you are trying to ensure against an unknown outcome.

Q54 The Chairman: Is a great deal of work being done, are you aware, on a lot of the issues that we have discussed today in advance of 2014, or do you envisage that a lot of the unravelling would take place after the vote, if there is one?

Professor Bell: I think that some work is being done, but I think that there is lots probably still to do. For example, we have discussed financial regulation, but we have not discussed the regulation of competition or communications or the energy market. All of those are additional big issues that would have to be resolved at some point, as well as all the others that we touched upon.

Q55 The Chairman: Aside from the issues that you have just mentioned, are there any other issues that we have left out in our questioning today?

Professor Bell: None immediately springs to mind.

The Chairman: It is comforting at least that we have the agenda fairly clear. Professor Bell, I thank you very much indeed. You have been most helpful to us in beginning to map out our inquiry and in raising all the issues, and we are very grateful to you.
British Academy—Written evidence

A response from the British Academy to the House of Lords Economic Affairs Committee enquiry, The Economic Implications for the United Kingdom of Scottish Independence

The British Academy, established by Royal Charter in 1902, champions and supports the humanities and social sciences across the UK and internationally. It aims to inspire, recognise and support excellence and high achievement. As a Fellowship of over 900 UK scholars and social scientists, elected for their distinction in research, the Academy is an independent and self-governing organisation, in receipt of public funding.

INTRODUCTORY COMMENTS

1. In responding to this enquiry, the British Academy does not wish to offer an opinion on whether Scotland should become independent from the United Kingdom, but instead to provide impartial evidence which may be of use to the committee in its current inquiry.

2. The British Academy Policy Centre, in partnership with the Royal Society of Edinburgh (RSE), held two conferences on Scotland’s relationship with the United Kingdom earlier this year: one in London and one in Edinburgh. The conferences were intended to bring further academic evidence and analysis to bear on the current debates surrounding Scotland’s relationship with the rest of the United Kingdom, and to inform and challenge the discussions both inside Scotland and in Westminster about the future of this relationship.

3. The London meeting examined three options that may emerge in the debate (independence; “devolution-max”; and the proposals in the Scotland Act) and explored the implications of each for the relationship between Scotland, the United Kingdom, and the European Union. The second leg of the conference, held in Edinburgh, looked at some of the political and economic challenges of independence, the union and greater devolution.

4. Both events were well attended, and featured presentations by leading academics and other experts. Further information on the conferences is included in Appendix 1.

5. The British Academy and the Royal Society of Edinburgh will be publishing a report of the two conferences later this year. In advance of that, the British Academy wishes to share some of the discussions that arose from the conferences and the expertise with the committee, with special focus being given at the end of this response to precedents set by other countries, thereby answering question five in the committee’s call for evidence. The following evidence is a summary of some of the presentations made and discussions had at the two conferences. Not all points would have been accepted by all speakers, but the below attempts to give a consensus view.
HOW DO THE NUMBERS ADD UP? TAXING AND SPENDING

6. One of the most hotly contested areas in the debate around Scottish independence is the impact it would have for the financial positions of both Scotland and the rest of the UK. Financial implications also appear to be central to the degree of support for independence from within the Scottish electorate. There are a number of disputed areas in the debate on finance, which it would be pertinent to look at in more detail. Broadly, these related to the overall fiscal situation in Scotland, relative to that of the UK, the rates of public spending in Scotland, and the potential sources of tax revenue in an independent Scotland.

What are the differences between the Scottish economy and that of the UK as a whole?

7. To begin with, it is important to establish how far the state of the current Scottish economy deviates from that of the UK as a whole. We can examine this issue by forming an aggregate index based on seven representative indicators.1 Comparing the aggregate difference of each region's ranking from the median (see figure 1) in fact reveals that the Scottish economy is well-matched to that of the UK as a whole, being one of the closest regions to the median. Far greater deviations can be found in the English regions of the South East (performing relatively better across the indicators) and the North East (performing relatively worse).

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1 The seven indicators used are: Knowledge intensive services (as % of total employment); R&D Spending by business as share of GDP; House Prices; Average Weekly Earnings; Unemployment Rate; Gross disposable household income (£ per head); Workplace-based gross value added (GVA) per head at current basic prices
8. What is more, it appears that, over time, business cycles, rates of inequality and unemployment rates in Scotland and the rest of the UK have all become more aligned; from divergences in the unemployment rates of England and Scotland of almost four percentage points in the mid-1980s, this gap has reduced to virtually zero since 2000. Rates of income inequality in Scotland are also now around average for the UK as a whole. Appeals to past economic differences are therefore becoming less relevant.

To what extent is Scotland benefiting from a generous public spending settlement?

9. Scotland’s apparently privileged position with regard to the distribution of UK public spending has been an ongoing source of dispute and engenders some dissatisfaction within the English electorate. But to what degree can it be claimed that Scotland is receiving more than its fair share of spending?

10. Figure 2, which shows all identifiable public spending, reveals that Scotland continues to receive a relatively generous public spending settlement with average figures well above the average for England and slightly above Wales. About 40% of this relates to social security entitlements, and most of the remainder is spending devolved to the Scottish Parliament. It is determined using the Barnett formula which might have led to a convergence in public spending per head across the UK, as long as public spending is increasing. However, while there have been some decreases in the disparities since the late 1990s, it has proved slow to take effect and public spending is in fact scheduled to decrease.

11. It is also important to examine the source of these differing rates of spending. The Scottish Government currently has no control of spending on social protection, most of which comes direct from the Department for Work and Pensions and may thus be linked to need to some degree; Scotland does have large inequalities, with a significant
proportion of the population qualifying for benefits and per capita spending on social protection at 8% above the UK average; similarly per capita spending on health, which is the largest element of devolved spending, is 7% above the UK average and is associated with a lower life expectancy than the rest of the UK.

**Will increased tax-raising powers allow the Scottish Government to boost Scotland’s economic growth?**

12. It could be argued that Scottish politicians have been too focused on the potential of increased tax-raising powers to generate economic growth. First, this focus has led to a tendency to ignore the role of the public spending powers currently under control of the Scottish Parliament – in areas such as infrastructure investment, business support, and human capital enhancement – which can be equally instrumental in affecting economic growth rates especially over the longer term. Secondly, Scottish politicians may also be ignoring some of the constraints on tax-raising powers. Much of this debate centres on business taxation, with calls to devolve corporation tax, so as to cut it and so encourage economic growth. However, the Scottish Government already has control over the other significant business tax – non-domestic rates – and has not pursued a tax-cutting policy in this area.

13. The most prominent area of debate around the Scottish taxation has been centred on Scotland’s oilfields. Many Scottish politicians have long argued that Scotland’s fiscal position would improve considerably were it able to take full control of its oil revenues. However, as Figure 3 illustrates, it appears the bulk of the fiscal benefits of oil revenue occurred between 1980 and 1987.

![Figure 3: UK Fiscal Balance with and without Oil Revenues](image)

14. This is linked to the fact that, since the mid-1990s, oil production has been declining steeply and prices fluctuate markedly. For both of these reasons, oil is no longer considered a stable source of revenue. This is not to say that oil revenues would have no
impact on Scotland’s fiscal balance; on 2009-10 National Statistics figures, Scotland’s fiscal deficit would have been over 17% of GDP excluding North Sea oil revenues, but just over 10% including Scotland’s geographical share of oil revenues (better than that of the UK as a whole). However, neither of these scenarios would represent a strong fiscal position for a small, newly-independent country.

15. The second set of taxation constraints include the following:

16. The Scottish economy would be unable to maintain a simultaneously low-tax/ high-spend position. The Scottish Government would have to contend with establishing a new, politically-palatable balance between tax and spend.

17. The outcomes of the major structural changes associated with independence will be uncertain. Outcomes may be better or worse, but bond markets are likely to extract a risk premium until these uncertainties are eliminated.

18. Agreeing the terms of separation will take time and involve substantial set-up costs. Debates will centre on the allocation of debt and assets, as well as new institutional arrangements.

19. Finally, there will inevitably be collisions. Parties other than the governments of Scotland and the rest of the UK will become involved in negotiations on an independent Scotland’s proposed fiscal arrangements. Questions likely to be raised include the prospect of fiscal integration with the Eurozone, and opposition from larger countries should Scotland seek to reduce taxation rates in line with other small country ‘tax havens’.

LESSONS FROM THE EUROZONE

20. As is the case with federations such as the United States, automatic stabilisers and risk sharing measures are part of the UK’s current fiscal system. In the event of a local shock, tax revenue goes down and social security payments go up, thus cushioning the shock. These would be lost by an independent Scotland, and thought would have to be given to how they could be replaced.

21. One alternative to having automatic stabilisers is to employ cyclical borrowing, as occurs in the eurozone where there is no central fiscal authority. But this method has proved to be risky, with eurozone countries suffering as a result.

22. An independent Scotland would naturally have scope for independent fiscal policies, e.g. internal fiscal stabilisation, and introduction of a low corporation tax rate in line with the Republic of Ireland or Crown dependencies like Guernsey and Jersey.

23. But there is doubt whether the latter would meet with approval from the EU. Such disapproval could have consequences if conditions for EU and possible eurozone membership have to be negotiated between the EU institutions and Scotland.
THE SEPARATION OF CZECHOSLOVAKIA

Overview:


25. Despite elements of Czechoslovakian history which prevent direct comparisons with the UK (for example the novelty of a convertible currency in Czechoslovakia—this made a currency split easier) the success of the separation in economic terms makes this precedent a useful one.

26. The competent handling of the separation was well recognised: trade was unhindered, and there was confidence in the two new currencies which emerged from the split. The processes used for the separation of the Czechoslovakian currency were recommended by the IMF to Moldova, Turkmenistan and Uzbekistan.

Background and process of separation:

27. Although not endorsed by the people of either part in referendum, the separation of Czechoslovakia was driven by the diverging economic and fiscal policies of the two parts of the federation, with the Czech government opting for faster paced reform towards a market-based economy.

28. Because of the economic causes for the separation, although the two countries agreed to retain a single currency its permanent continuation was not envisaged. Separation of both federation and currency was a plausible option thanks to favourable economic conditions, namely: (1) low foreign debt, (2) relatively high household consumption, (3) sound government budgets, (4) reasonable inflation rate. However, it was anticipated that a common currency might last for several years after the separation of the countries, and appropriate joint arrangements were put in place ahead of the separation. The single currency however collapsed in a matter of weeks, and arrangements had to be made hurriedly to split it: these were predominantly successful, and made possible largely because the country did not have a convertible currency and retained exchange controls.

29. There was a carefully orchestrated media campaign to ensure that citizens knew about technical factors in exchanging their money, and limits were placed on how much money could be exchanged over the counter.

30. Together with stamping notes (eventually deemed to be the best way of separating cash—money in banks was simply renamed according to the new currency), the entire process of currency separation proved to be labour intensive, with preparations being made in July 1992 for ultimate currency separation, well before the separation of Czechoslovakia.

31. In the event, speculative flows against Slovakia began immediately on separation, and the currency union lasted only five weeks instead of the anticipated three years. One important lesson from the way separation of currency was handled relates to the prevention of bank runs: the anticipation of the devaluation of a currency can lead to
rapid depletion of banks, as started to occur in Slovakia immediately on separation. In order to cater against speculation of this kind, cross-border transfers were suspended by both parties.

32. Although not all commentators are convinced the same kind of speculation is a likely outcome for Scotland in the eventuality of independence, the need to carefully consider it as a possibility was stressed at the conference.

33. The division of federal property in Czechoslovakia proved to be a complex process and required high-level political negotiations. For many assets, a two-to-one principle was employed, but immovable assets and deposits in commercial banks were instead divided according to a territorial principle. For assets and liabilities against the IMF and certain other kinds of property, e.g. gold reserves, special arrangements had to be reached.

Outcomes:

34. In the longer term, there were no notable divergences in GDP annual growth between the two countries following the separation of Czechoslovakia. Initially growth was slower in Slovakia. However, Slovakia soon overtook the Czech Republic in its growth. This was largely the result of an increase in competitiveness in foreign trade for Slovakia owing to the devaluation of the Slovak koruna (the same phenomenon which has contributed to UK competitiveness in recent years).

35. This suggests that even an unbalanced splitting of the economic base need not necessarily lead to future discrepancies in growth, especially when two economic regions have traditionally been closely tied. The two countries retained fairly similar monetary policies and continued to show similar levels of inflation.

36. The immediate separation itself was inflation-neutral. Gloomy predictions about the future of Slovakia’s economy turned out to be unfounded, with the country meeting the economic standards necessary to join the EU.

Irish Independence

37. Ireland became a Free State within the British Empire in 1922. It took on all the features of a republic in 1937, although it did not formally become one until 1949.

38. These constitutional developments did not drastically alter the course of Ireland’s monetary policy, with the Irish pound being retained at parity with sterling until 1979. Sterling notes and coins circulated freely in the Irish Republic until then.

39. However, independence did mean Ireland was able to take autonomous decisions regarding its economy. After an autarkic spell from the 1930s to the 1960s, it brought in initiatives to boost trade in the 1960s and it became more competitive after joining the EU alongside the UK.
CONCLUDING REMARKS

40. The close integration of Scotland’s economy with that of the UK, together with some of the precedents so far considered, tends to suggest that factors like growth and inflation could remain similar even if Scotland did withdraw from the Union.

41. However, the relatively volatile factor of the North Sea oil revenues will have a part to play in the future of Scotland’s economy. Whether or not it is well suited to independence in terms of factors like fiscal debt rest heavily upon this source of income.

42. Much of the division of assets in Czechoslovakia was made according to a population shares principle, a way forward currently floated as viable for Scotland if it were to become independent. But at the same time, much debate was needed over the division of debt and certain kinds of asset, a reminder that division of assets is never going to be straightforward.

43. Lastly, uncertainties over the outcomes that major structural changes associated with independence would bring, and the precedents considered above should in no way be taken as sure indicators of what would happen to the economy of an independent Scotland.

June 2012
TUESDAY 17 JULY 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Lawson of Blaby
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witnesses

Professor Iain McLean, Professor of Politics, Oxford University and Fellow of Nuffield College; and Paul Ingram, Executive Director of British American Security Information Council.

Q430 The Chairman: Good afternoon, and welcome to the Economic Affairs Committee. This is our ninth public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. I just have to repeat that hard copies of Members’ entries in the Register of Interests are available in the room.

Dr McLean and Mr Ingram, thank you very much for coming, and thank you Dr McLean in particular for the written evidence you have given us, on which we will have a number of questions and which we found very interesting. I should be grateful if you would speak loud and clear for the webcast and the shorthand writer. Would you like to make an opening statement or can we go straight to questions?

Professor Iain McLean: For the sake of the webcast, I apologise for signalling problems outside Reading; otherwise I am happy to let my evidence—
The Chairman: We apologise that we had domestic matters to consider, so it did not really cause a problem. Perhaps I may begin with a very general question. Both in your written evidence and in evidence from a lot of other witnesses, there has been a lot of stress on the need for negotiation over many of the important issues. We readily recognise that. In your view, how long might these negotiations take? It is fairly clear from your paper but could you just also spell out which you think are the key issues? Do you think that that long period of negotiation might act as a disincentive or have a negative impact on businesses and on the perception of the economies and so on in the meanwhile?

Professor Iain McLean: Thank you, Chairman. The two analogies that I have studied are the case of Ireland in 1921 and the Czech and Slovak Republics in 1992 to 1993. In both those cases, once a split had been decided on, the negotiations were, one might say, remarkably quick. In the Irish case, discussions began in October 1921 and they were concluded on 6 December of that year. In the Czech and Slovak case, negotiations began after the last federal election in June 1992 and were concluded in time for a split-up on 1 January 1993. This was then followed by a monetary union, which lasted in effect only a matter of days. Other cases which could be possible analogies, such as the break-up of Yugoslavia, I am not qualified to comment on.

Would a Scottish/rest of UK negotiation be comparable with those? In one sense, it might be less rapid because in both those cases it was negotiation under duress. In the UK/Irish case, the Government of Lloyd George were threatening to revoke the truce that was in place, and the Irish, among themselves, thought that they might lose any ensuing war. In the Czech/Slovak case, the urgency was driven by the currency issue, which was recognised by all the bargainers as needing an urgent solution. In the Scotland/UK case, we might say that there would be no hurry because there are none of these wars or potential wars that would have affected the Irish or Yugoslav cases.

On the other hand, I think that the currency and financial regulation issue would add urgency to the bargaining. There could be risks, such as a speculative run on the expected depreciation of the Scottish pound, which could give it the same degree of urgency as in the Czech/Slovak case. Of course, to answer your final question, this could lead to quite a lot of—to put it mildly—anxiety on the part of agents, especially financial businesses in Scotland, although I think somewhat less so in the rest of the UK. That then leads to the conclusion that the rest of the UK would be in less of a hurry than the Scottish negotiators, which gives rather a close analogy with Ireland in 1921.

Lord Lawson of Blaby: For the avoidance of doubt, can you confirm that what you are talking about is negotiations after the referendum in the event of the referendum going in favour of independence, rather than the possibility of negotiations before?

Professor Iain McLean: Correct. I am sorry; I should have made that clear.

The Chairman: There are also a lot of witnesses who are saying that you cannot have a sensible referendum unless there is a proper analysis of some of the key issues—and I think we all know what the key issues now are. Would you agree with that?

Professor Iain McLean: Absolutely. With colleagues, I am trying to supply some of that non-partisan evidence. Members will be aware that the British Academy and the Royal Society of Edinburgh have a joint initiative on these matters. I have just learnt that the Economic and Social Research Council has issued a call for proposals, which I intend to respond to. So I think that serious academic analysis of a non-partisan sort is starting to
happen. You may feel that it is now rather short notice before the referendum date but it is starting to happen.

**Q434 The Chairman:** One of the problems being identified is that many of the issues will be subject to negotiation and, because of that, the analysis cannot be clear-cut.

**Professor Iain McLean:** I agree.

**Q435 Lord Tugendhat:** You raise some very interesting defence-related points in your paper. Perhaps I may ask a very basic question. Can you give us an idea of the overall number of servicemen posted at defence bases in Scotland and, more to the point, the number of civilian jobs supported by those bases?

**Paul Ingram:** The latest figures available suggest that there are somewhere in the region of 12,000 service personnel in Scotland, although that does not take into account changes since 2010, which of course are reasonably substantial as a result of the SDSR and the plans after that. The number for civilian personnel is just under 6,000, and the estimate for the defence industry is 12,500. The numbers are always a little uncertain around the defence industry because it is very difficult to categorise when we are talking about subcontractors and when we are talking about secondary suppliers, who are, by their very nature, dual-use. The impact of any decision is clearly uncertain. I may be running ahead of you there but those are the current numbers.

**Q436 Lord Tugendhat:** Would you agree with me that, to some degree, your reply understates the economic impact of the bases? I have in mind two things. I cannot remember what the big base was in Essex but when the Americans ran it down, although Essex is a very prosperous part of the country, being close to London and so forth, that caused a lot of disruption to the local economy. Perhaps a more interesting example is that when the Americans started to run down their very substantial establishment in Germany, a number of German communities actually pleaded with the Americans to stay because they had been there a long time and the local economies, to some extent, regarded the American bases as part of the fabric of their local society. I should have thought that to some extent the same might apply in Scotland.

**Paul Ingram:** The numbers that I just quoted to you were for direct service personnel—civilians employed directly on the bases—and for defence industry suppliers specifically. I was not talking about multiplier effects within the community in the way that you would describe—

**Lord Tugendhat:** You mean shops and all the rest of it.

**Paul Ingram:** Exactly. Every transition is costly when it comes to economic transitions such as these. That does not mean to say that those shops may not find other sources of income in the future, but there are inevitably transitionary costs, which are larger than the main numbers that I was describing just now.

**Q437 Lord Lipsey:** To put the numbers in context, how does this compare with the percentages in areas in the rest of the UK which are involved in similar ways? Is it particularly defence-intensive or defence-light in Scotland or what?

**Paul Ingram:** It is more defence-intensive in Scotland in terms of the number of service personnel who are from Scotland compared with the rest of the UK—not significantly more but a little more. Many of those service personnel from Scotland are not based in Scotland, so the economic multiplier effects that we were describing are not all simply because they
are Scottish service personnel. If we simply look at the number of bases and the number of Scottish personnel who are deployed in Scotland, it is roughly equal to the rest of the United Kingdom.

Q438 The Chairman: I do not know whether you saw Francis Tusa’s evidence to the Scottish Affairs Select Committee of the House of Commons in May. One of the arguments has been that Trident could not be moved from Scotland very easily and that the cost of such a move would be very high. I think that at one point he described it as “one of the biggest red herrings”. He was arguing that they could very easily be deployed elsewhere in the United Kingdom. Have you any view on that?

Paul Ingram: It is certainly not what the Minister for the Armed Services said a few weeks back in evidence. It is the opinion of many analysts within my community that there are significant problems with relocation, and not just the actual porting of the submarines, which is manageable—obviously submarines already go into Devonport for refits and the like. The principal challenge is the location of the armouries for the nuclear warheads, along with the inevitable public inquiries, the political impact and the geological basis, which implies health and safety. At the moment, at Coulport there are of the order of 2,000 to 3,000 residents who would be at risk if there were an accidental nuclear explosion. If we were to base nuclear weapons in Devonport, you could look at a factor much larger than that, with local impacts when it came to the political fear of having these stationed, and that would create all sorts of challenges. There is certainly a financial cost when it comes to upgrading the bases elsewhere to take these weapons. Nick Harvey, the junior Minister, has given an estimate of the order of tens of billions of pounds. He has not gone into that. He did not have any Civil Service back-up for that number but he based that estimate on the fact that they have already spent, in recent times, £3.5 billion to upgrade the Faslane facilities to take the Vanguard and Astute class submarines. So one could assume that building facilities from scratch would cost a great deal more than the £3.5 billion that has already been spent. Therefore, there are financial costs but there also are a number of other significant costs that would make it difficult.

Q439 Lord Forsyth of Drumlean: Just on the Francis Tusa point, I do not know whether you read the evidence that he gave to the Scottish Affairs Select Committee.

Paul Ingram: No, I did not.

Lord Forsyth of Drumlean: On the point about the storage of the warheads and the issues which you have said are raised by the Defence Minister among others, he said, “It is very easy. Aldermaston and Burghfield have spare storage capability and have full nuclear licences. Coulport is sized for a deterrent with five”, and then he was interrupted. He was implying that there were no difficulties at all.

Paul Ingram: If one were to store the warheads at Aldermaston and Burghfield, which would indeed be a rational thing to do, you would still need to have the loading facilities. You obviously cannot load a submarine at Aldermaston or Burghfield, and you would need some temporary storage facilities because you could not do this sort of activity on an off-the-shelf, immediate basis. It would not satisfy health and safety procedures.

Q440 Lord Forsyth of Drumlean: For someone who operates on soundbites, in your view what would the cost of moving the nuclear deterrent out of Scotland be, and how many jobs would be lost as a result?
Paul Ingram: My view is that we are looking at a cost of the order of at least £7 billion or £8 billion. I have been looking at the costs of a number of different options recently and that is the sort of level that we would be looking at.

Q441 Lord Forsyth of Drumlean: And the number of jobs, direct and indirect?

Paul Ingram: Jobs lost in Scotland are of course jobs going elsewhere.

Lord Forsyth of Drumlean: I have a bias towards the numbers in Scotland.

Paul Ingram: For jobs lost in Scotland, we are probably looking at the order of 2,000.

Q442 Lord Lawson of Blaby: If it is considered important that the United Kingdom retains an independent nuclear deterrent, it is difficult to see how that could possibly make sense if you were based outside the United Kingdom. So that cost would have to be met. Are you suggesting that somehow the United Kingdom might have a sovereign base in Scotland analogous to what we used to have in Cyprus?

Paul Ingram: What I am suggesting is that there are a number of different options to be negotiated. This side of a referendum, for all the reasons that we talked about earlier, it is difficult to judge how that would come out, but it would certainly be in the strong interests of London to maintain the base up in Faslane. Because of the costs and because of the complexities, we would be looking to try to maintain those facilities in Faslane for as long as possible.

Lord Forsyth of Drumlean: But the nationalists have a clear policy, which is to remove nuclear weapons from Scottish soil. That is a long-standing policy, so Lord Lawson’s question is—

Paul Ingram: It is very pertinent and also extremely difficult for me to answer, because it is more of a political question of how much the Members of the new Scottish Government will be prepared to face down either their domestic public or the pressures coming from London. At this point in time, I do not think it is very easy to give you a clear, definitive judgment as to how that would pan out.

Q443 Lord Forsyth of Drumlean: One other quick soundbite question. Assuming that the nationalists were as good as their word and wanted the independent deterrent out of Scotland, how long would our independent nuclear deterrent not be working while this process was achieved? Or would it be possible to continue to operate it in those circumstances?

Paul Ingram: If the Scots were to force the closure of Faslane and Coulport within the space of a few months, it would obviously take several years to build alternative facilities. My prediction is that, if the Scots were willing to take the political consequences of such a decision, which would be significant, then the rest of the United Kingdom, were it to decide that it would retain continuous at-sea deterrence, would do so out of King’s Bay, Georgia or indeed it may even come to an agreement with the French to use the Brest facilities. There are no facilities that it could use with any confidence in England in the mean time.

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2 “This is probably an underestimate. There are of the order of 3000 service personnel and 4000 civilian personnel including contractors (mainly Babcock) currently based at Faslane and Coulport combined. This is the main navy port in Scotland, and it is likely that there would remain some navy presence after the removal of facilities associated with the nuclear deterrent, so job losses would be of the order of 7000 minus any jobs created by the new navy.”

3 It should be noted that both these options come with considerable logistical as well as political challenges that should not be underestimated… not least on the transport of British nuclear warheads for storage and loading.
Professor Iain McLean: May I come in with a supplementary to both those questions? I have discussed the sovereign base issue in written evidence, which Members will have seen. I draw attention to the fact that the United Kingdom and Ireland, which had been in a guerrilla war for two years, were able to come with remarkably little controversy to an agreement that the UK should retain three sovereign bases in what was then the Irish Free State. No less a person than Michael Collins was perfectly happy to agree to this. So the way that I would see the scenario which Lord Forsyth and Lord Lawson are developing is that, if the Scottish Government's first move was to say, “They have to be out in six months”, the rest of the UK negotiators would say, “Okay, in that case you can forget about any of the negotiations about the other things which you need”—such as financial regulation, which no doubt we will come to later. So my prediction, for what it is worth, is that, although that might be the first move, it would not be the final one and in that event I would envisage a sovereign base agreement being able to be reached.

Of course, this is affected, as we speak, by what appears to be a change in SNP policy. The clerk has just sent us a note of a story from BBC Scotland today which has been in the air and presumably Members have also seen it. The SNP defence spokesman is actively trying to alter his party's stance on NATO, and of course none of us knows what the outcome of that will be.

Lord Forsyth of Drumlean: On NATO but not on the nuclear deterrent.

Professor Iain McLean: On NATO but not on the nuclear deterrent. That is correct. I presume that it is unnecessary for me to read this out. I dare say that it has occurred to Members of the Committee to ask Mr Robertson to appear before them to answer that question.

Q444 Lord McFall of Alcluith: Would that be equivalent to banks setting up branches in different areas which, in the case of Scotland, would be a bank without any money? Is that a comparable analogy? They want to get rid of the nuclear weapons but they want to be members of NATO. Paul, the point I would like to make to you is that Faslane and Coulport are in an area of Scotland where comparatively unemployment has been historically high. Would the 2,000 job loses you are talking about be concentrated locally?

Paul Ingram: Yes.

Q445 The Chairman: And the 2,000 job losses would be direct job losses? You are not calculating the other effects?

Paul Ingram: There would probably be another 2,000 or 3,000 jobs that would be affected in one way or another.

Lord McFall of Alcluith: Locally?

Paul Ingram: Yes. With regard to NATO, I would like to draw your Lordships' attention to the example of Norway. It is a very loyal member of NATO. It sits on the Nuclear Planning Group and indeed supports, as all NATO members do, the policy of NATO remaining a nuclear alliance for the foreseeable future for as long as other countries have nuclear weapons. Norway also has a policy of banning any nuclear weapons on its territory in peace time, and that is a policy that it has maintained for quite some years. It is also probably the largest funder of non-governmental organisations working to reduce the salience of nuclear weapons in global politics. So it seems to be able to have that dual policy—or two-faced policy, you could say, although I would not like to be quoted on that; perhaps I should say “looking both ways”. NATO is often a very flexible organisation that has been able to deploy
in all sorts of different environments in a flexible way, and its members are equally flexible when it comes to their interpretation of what their responsibilities are.

**Q446 Lord Forsyth of Drumlean:** Just on that, you drew our attention to the BBC press release and the statement that is being made, which suggests that an independent Scotland, as a member of NATO, would take part in an operation only if it were sanctioned by the United Nations. I thought that the whole idea of NATO was that if one was attacked, all came to the defence, and that you could not go to the United Nations to say, “Is it all right?” Is that wrong?

**Paul Ingram:** Under international law, UN Charter Article 51 gives every state the right to self-defence. The alliance makes that a multinational responsibility and ability. My interpretation—and it may be wrong—of what he is saying there is that the Scots would not go out of area to fight wars outside of NATO without United Nations endorsement. However, I am not a member of the SNP and that would just be my interpretation.

**Lord Forsyth of Drumlean:** I was just asking whether that is within the NATO rules.

**Paul Ingram:** It is within the NATO rules to be a NATO state and not engage in a NATO operation out of area that is not an Article 5 operation under the North Atlantic Treaty.

**Lord Forsyth of Drumlean:** But if it was an Article 5 operation?

**Paul Ingram:** Article 5 is part of the NATO treaty—the North Atlantic Treaty—that talks about each member making a commitment to collective self-defence. It is self-defence that is important; it is not defence of interests outside of area.

**Q447 Lord Smith of Clifton:** We have more or less covered the question that I was going to ask. My colleagues have encroached on it, not for the first time in my experience. Turning from defence, if an independent Scotland were to use sterling as its currency, do you envisage any arrangements whereby the Bank of England could have responsibility for providing services, such as lender of last resort, to Scottish-based institutions? Would it be preferable for an independent Scotland to have its own monetary authority or central bank? Are there lessons from history of what a preferred arrangement might look like between two separating countries?

**Professor Iain McLean:** That is a large question, and I hope your Lordships will forgive me for giving a rather complex answer to it. Current Scottish Ministers, including the Finance Minister, John Swinney, have suggested that the contingencies raised by Lord Smith are irrelevant on the grounds that an independent Scotland would simply adopt the pound sterling as its currency without consulting the rest of the UK. There have been analogies to this. Ecuador and Argentina have adopted the US dollar, and Montenegro has adopted the euro. However, I think that that is a soundbite for domestic consumption—although you would have to probe this with Mr Swinney and not with us—because I do not think that it is a realistic bargaining stance. Were that to be suggested after a yes vote on independence, the effect on the morale of Scottish financial institutions would be considerable. Scottish financial institutions are going to need certainty as quickly as possible on the range of questions which Lord Smith has just raised.

In realistic bargaining between the Scottish delegation and the rest of the UK delegation, it seems to me that the Scots must either ask for Bank of England responsibility for the services you mention in your question or they must offer a set of arrangements that the rest of the UK, and most significantly the Bank of England itself, regard as acceptable. In my view, and I am far from the only one who takes this view, the two issues that are likely to be the
British American Security Information Council (BASIC) and Professor Iain McLean—Oral evidence (QQ 430-481)

most crucial in post-referendum negotiations are the one that we have just discussed—nuclear weapons—and the one which Lord Smith has just raised.

You asked me to talk about international comparisons, and I am very grateful to the clerks, who gave me some notice of this question so that I could do a little bit of research. In the Czech/Slovak case of 1993, it is important to say at the outset that the monetary authorities of the two countries worked entirely harmoniously. They both realised that splitting the currency needed to be done with extreme urgency, with quite a degree of secrecy and with arrangements such that there was not a run on the banks in either country or, in particular, a run on the banks in Slovakia. So it can be done by agreement. I think that the position enunciated by the Scottish Finance Minister is unrealistic—that Scotland might simply unilaterally do something and not even bother to seek negotiations with the rest of the UK or walk out of negotiations with the rest of the UK. I think that the effect on the Scottish financial sector of even threatening that, let alone doing it, would be calamitous.

Q448 Lord Smith of Clifton: Do you think that there will be a pre-emptive strike by Scottish banks whereby they might, in anticipation, hive off their English activities and register them in London, as indeed the Irish banks have now done following the eurozone crisis? I am talking about banks here which were protected by the Bank of England and by regulatory rules here.

Professor Iain McLean: The issues relating to retail banks and investment banks are different. Let us take the case of the retail banks. I think that they would be very remiss if they were not making those plans already. On the other hand, if you were to call the Scottish retail banks to give evidence, you would not get anything out of them, for obvious reasons. Therefore, I cannot confirm for sure that they are making those arrangements already. However, of the Scottish-domiciled retail banks, RBS and HBOS have the majority of their UK customers in the rest of the UK. I do not know about Clydesdale Bank but certainly a lot of its customers will be in the rest of the UK. So those customers would come under UK regulations in any case, whether or not the banks took any active steps to regulate them.

As regards investment banking, I have almost no expertise in the subject but I would have thought that the Scottish and London investment banking markets or arenas are so integrated that any operations that go on in Scotland could be quickly transferred to London, but that is going outside my area of expertise.

Q449 Lord Smith of Clifton: Professor McLean, if it looked as though the strength of support for independence in Scotland was growing, do you think there would be a flight of capital generally and commercial activity away from Scotland to England or elsewhere in the UK, as happened in the case of Canada, when it looked like Quebec might go separate and business fled from Montreal to Toronto?

Professor Iain McLean: That is a possible analogy. On the other hand, for what it is worth, that did not happen in the Czech/Slovak case, even after it became clear that there was going to be a split. It should be borne in mind that that did not become clear until after the election and after the leaders of the Czech and Slovak federal units set out their stalls. In that case, there were immediate serious monetary issues but not serious capital flight issues. One might say that in Canada in 1995 capital was more mobile because it was a mature capitalist economy, whereas the Czech Republic and Slovakia were emergent economies at the time, so it may be that the Canadian scenario is more realistic than the Czech/Slovak
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Q450 Lord Lawson of Blaby: The point that you made about Canada being much more highly developed financially than central Europe at that time is very important. The other point is the size disparity. Although the Czech Republic and Slovakia are not of equal size, the disparity is nothing like as great as that between Scotland and the rest of the United Kingdom. I think that this is a further reason for suggesting that the Czech and Slovak precedent is not all that compelling.

Professor Iain McLean: I believe that it is compelling in some respects and not in others. To put it on the record, the population ratio of Czechs to Slovaks is about 2:1 compared with about 9:1 for the rest of the UK to Scotland. Let me also take the opportunity to say that the UK’s greatest expert on this, if you want to probe this further, is Karen Henderson of the University of Leicester, and I can give the clerks her particulars. She knows far more about this than I do.

Q451 Lord Shipley: I want to pursue the issue of regulation. Your written evidence suggests that the rest of the UK would have an interest in financial regulation or perhaps “clearing” regulation in Scotland. I would be interested to know more about what you have in mind. If the rest of the UK were to regulate Scottish institutions, would this not imply some liability if they failed? Is it possible for governance by a single regulatory authority to be accountable to two separate Governments?

Professor Iain McLean: These are also very weighty questions, so, once again, I thank the clerks for giving me notice that they might be raised. I have done some research, including speaking to a former member of the Monetary Policy Committee about these issues. A way to look at this would be to consider the bargaining table from the point of view of the rest of the UK negotiators. Their interest, it seems to me, would be in the status of the currency and our financial regulation in the rest of the UK, and in any contagion, spill-over or consequences that would undoubtedly be in their minds from the recent examples of Greece, Iceland and Ireland, and possibly other examples which may have occurred by the time these negotiations take place. Therefore, I envisage that the rest of the UK negotiators are going to be bargaining very hard and are not going to let the Scottish negotiators get any of the things which the Scots will predictably want—we know that the current Scottish Government have signalled some of the things that they will be looking for—unless the rest of the UK negotiators are completely satisfied that there is, from their point of view, a watertight regulatory system.

Because of the “One Man, Two Guvnors” problem which you have just raised, I suspect that a single regulator is not feasible, and therefore the rest of the UK negotiators would have to be content that the proposed Scottish regulatory structure was tight enough to satisfy the concern of preventing contagion. I do not know whether that is helpful.

Q452 Lord Shipley: As I understand it, you are saying that there would need to be separate systems of regulation. But do you think there is any danger in an independent Scotland of firms or financial institutions simply getting too big for the regulatory system that underpins them? Should that happen, might that be a fall-out of the rest of the UK being the place of last resort for help?

Professor Iain McLean: The most obvious cases which are already in everybody’s minds are the two very large Scottish-domiciled banks, RBS and what is now Lloyds TSB, or the former Bank of Scotland component of that. That problem already exists but they are covered by
the UK regulator. Undoubtedly, to follow on from my previous answer, if you agreed that you had to have two regulators, then those banks would have to split their Scottish operations from the rest of the UK operations in any case, and those would be regulated by the two different regulators. I sense behind the question some worry that this might create a new moral hazard to the effect that such banks might let some of their operations in Scotland go more recklessly than they otherwise would because they would think that the rest of the UK regulator would mop up any trouble. I cannot predict how that would go but I can see it as a possible risk.

In relation to non-bank regulated financial firms such as asset managers and so on, I think that my answer has to be rather similar. The Scottish regulatory regime will have to be very similar to the rest of the UK regulatory regime or the rest of the UK will not sign off on the independence deal for the same reason—that the rest of the UK would have a very urgent interest in preventing, just to pick at a venture, Aberdeen Asset Management from doing things under Scottish regulation that it would not be allowed to do under rest of the UK regulation.

Q453 Lord Shipley: Is there a danger that some financial firms might migrate in either direction? Might that scenario have an implication for the movement of jobs?

Professor Iain McLean: Yes, but my answer would be the same as the one that Paul gave earlier. The implications would be neutral for the present UK. Firms might move from Scotland to the rest of the UK or vice versa. But from the point of view of the population of the present UK, that is a separate issue.

Q454 The Chairman: If the system of regulation in Scotland was not as tight as it was in England or if the lender of last resort situation was very different and very unclear, is there not a risk that the international financial community would look much less favourably on Scottish institutions?

Professor Iain McLean: And on Scottish debt. Yes, that is certainly true.

Q455 Lord Forsyth of Drumlean: I do not want to put words into your mouth but I was just imagining that I was the chief executive or chairman of the Royal Bank of Scotland—not a happy prospect—and was faced with this. Under your scenario, I am going to have to have a different regulatory regime for my business in Scotland. I already have very high compliance costs in dealing with the existing regulatory regime. I am also going to have to operate in an environment where the cost of capital is likely to be higher because of the size of the country’s balance sheet, and I am conscious that the Governor of the Bank of England has been telling everyone that the banks are too large relative to the balance sheet of the United Kingdom as a whole. Would I not be telling my board that we had to get out of Scotland?

Professor Iain McLean: I shall resist the temptation of having you put words in my mouth, Lord Forsyth.

Lord Forsyth of Drumlean: But can you explain why I am wrong?

Professor Iain McLean: I think that what you said does follow logically from the sequence of questions posed by Lord Shipley and from my agreeing with him that it is probably not feasible, post independence, to have a single regulator for the two financial regimes because that regulator would be reporting to two Governments who would have different policy objectives. Therefore, I think it follows that there has to be a Scottish regulator and that therefore, as you rightly said, there will be extra compliance costs for Scottish-domiciled
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institutions. Whether the Royal Bank of Scotland would decide that it would leave the country in which it was founded in 1727 in order to deal with the Scottish equivalent—the money that came in to compensate the Scots for the Act of Union—and abandon Dundas House in St Andrew Square is a cultural question as well as a financial one, to which I think the likely answer is no.

Q456 Lord Forsyth of Drumlean: But a cost gradient would be imposed on financial organisations such as the Bank of Scotland, which, after all, was founded before the Royal Bank of Scotland in 1695 and did a deal with Lloyds and HBOS which was apparently driven by commercial considerations. The point I am getting at is: is the consequence of this that the cost of doing business in Scotland if you are a bank will be higher?

Professor Iain McLean: All other things being equal, the answer has to be yes.

Q457 Lord Hollick: I am struggling to understand how the Scottish banks get past day one. Currently, the inter-bank market is frozen. One way that banks can finance themselves is through the central bank. The Bank of England effectively sits in the middle of the spider’s web at the moment. In those circumstances, without a central bank or the remaining part of the UK monetary framework, those Scottish banks which need to fund themselves on the wholesale markets—which would be the case for the two you have mentioned, even if you had hived off their London and international sides—would run out of money on day one.

Professor Iain McLean: I think that that is over-pessimistic because there would have to be a Scottish central bank. The question therefore would not be so much the credibility of the Scottish operations of the Scottish retail banks or the credibility of the Scottish financial banks. At least none of the Scottish retail banks that we have been discussing is only Scottish. RBS and HBOS we have discussed, and Clydesdale has international links. There may be an issue which I am not competent to answer—and I hope you will call for evidence from those who are—on, for instance, the position of smaller Scottish building societies and so on. I think that there is a serious issue there and I regret that it would just be stupid of me to attempt to answer a question that is outside my competence.

Q458 Lord Hollick: Being a central bank, you can print your own currency. When it is not your own currency, you do not have that option.

Professor Iain McLean: That speaks to the three options, none of them hugely attractive, that would face the Scottish Government on the currency question, which has been rehearsed in front of you before, which are sterling—in which case, on what terms?—the Scots pound or the euro.

Q459 Lord Lipsey: At the moment, the United Kingdom has about 100 double taxation agreements with other countries, and Scotland would lose the benefit of those once independent. How quickly and how satisfactorily do you think it could negotiate replacement agreements of its own?

Professor Iain McLean: My first reaction—but again I am outside my comfort zone here—is that that is not a huge issue. There would be two things that the Scottish Government would have to negotiate. One is the double taxation agreement with the rest of the UK and the other is what it does as a successor state with all the existing UK DTAs with the rest of the world. In both those cases, the tax structure, the tax base and the tax rates are going to start on day one as being identical. Although, for sure, you should ask a witness from HMRC or an expert on these matters this question as well as asking me, my first reaction is that
that would be one of the more tractable issues that could be dealt with in the independence negotiations.

**Q460 Lord Hollick:** Taxation is one of the areas that we have discussed with a number of witnesses—in particular, the ability of an independent Scotland to set its own tax rate and possibly follow the example of Ireland, which has been so successful in having low corporation rates and attracting quite a lot of companies to headquarter in Dublin. Do you think that that same opportunity exists for an independent Scotland or do you think, going back to the previous point about the double taxation agreements, you need to agree them with 100 countries, many of them in the European Union? Would they say, “Why should we agree to this if in fact all you are going to do is reduce corporation tax and take some of our company’s headquarters to your country?” Is it a realistic prospect that an independent Scotland will have a significant degree of flexibility over its tax rates?

**Professor Iain McLean:** My one-word answer is no, for at least two independent reasons. The first is that the expert briefing paper you have had from Professor Rowthorn, which uses the numbers published by the Scottish Government in the GERS series, which I hope all Members are familiar with, shows that the day-one fiscal position of an independent Scotland would not be strong and therefore there would be very little, if any, scope for cutting any tax unless you also cut the level of public services.

The second reason is, as you alluded to in your question, Lord Hollick, that the EU in particular would take a particularly dim view of any promise by the Scottish Government to reduce corporation tax, just as it has taken an extremely dim view over the decades of the Republic of Ireland having done the same thing, and it has tried to bring some pressure to bear. The Republic of Ireland has its corporation tax level and it would be more difficult for the EU to force the Republic of Ireland to raise its corporation tax than it would be for the EU to make a condition of Scottish accession on terms which Scotland would be happy with that it does not reduce its corporation tax. Although I notice that there is huge political noise on this question both in Scotland and in Northern Ireland, it seems to me that the politicians of all parties who are saying that Scotland could reduce corporation tax are living in a fantasy land—in the short term, at any rate.

**Q461 Lord McFall of Alcluith:** The question of how much fiscal latitude Scotland would have has been mentioned. Do you think that fiscal rules would be necessary both for the rest of the UK and for Scotland to limit the risk being taken?

**Professor Iain McLean:** Yes. An independent Scotland would have to have conservative fiscal rules: first, as a matter of simple prudence; secondly, because its debt has to be credible so as not to attract penal rates; and, thirdly, because it would be in negotiations with the EU, which would, on current arrangements, require it to meet the Maastricht criteria. That would therefore imply that an independent Scotland must have conservative fiscal rules, which might indeed look somewhat like Prime Minister Brown’s fiscal rules, but I cannot see further into my crystal ball than that.

**Q462 Lord McFall of Alcluith:** In your experience, have similar fiscal rules for limiting sovereign debt and borrowing in other countries worked?

**Professor Iain McLean:** Have they worked? That is a question beyond my expertise, I am afraid. I merely observe that there is chaos in a number of EU member states which purportedly have had fiscal rules but in fact have not.
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Q463 Lord McFall of Alcluith: To add to that, do you think it would be feasible to design and police such rules so that they would be effective, or is that just adding to the last question that chaos rules in the EU?

Professor Iain McLean: If I were John Swinney and if he were the first Finance Minister of an independent Scotland, I think I would beat a path to North Queensferry, knock on Gordon Brown’s door and say, “Please could you tell us how you devised and policed the golden rule and the sustainable investment rule, and how you would organise them if you were doing it again?”. In my view, there was nothing wrong with those as rules. What was wrong was the implementation of them in the latter years of the British Labour Government.

Q464 Lord McFall of Alcluith: Do you think there would be any friction in that relationship with fiscal rules and a fiscal pact?

Professor Iain McLean: There might be friction between the Scottish Chief Secretary to the Treasury and the rest of the Scottish Administration, but that would happen in any—

Q465 Lord McFall of Alcluith: In other words, how much fiscal latitude would there be for Scotland if it signed up to fiscal rules? It would have to have conservative fiscal policy not dissimilar to the rest of the UK.

Professor Iain McLean: Very little. On the current GERS numbers—of course, that is now and not in two years’ time—to achieve a fiscal balance Scotland must either increase taxation or reduce services or both. That is even on the assumption most favourable to the Scottish Government that oil revenue remains buoyant.

Q466 The Chairman: Perhaps I could come in on the oil revenue point. A number of our witnesses have suggested that, apart from the declining oil revenue, the real issue is its volatility. In the situation that you are describing, volatility of a major source of revenue would be a serious issue heavily affecting the fiscal rules.

Professor Iain McLean: I agree, and that is an issue which is urgent for Scottish Ministers to address. All I can do is agree with you that it is a big issue. Current Scottish Ministers, notably in the last Scottish election, were, if I may say so without being rude, intent on spending the oil revenue twice—first, as a sovereign wealth fund and, secondly, to fund current spending. I would hope that before the referendum the actual intentions of those who would like Scotland to be independent are disentangled on this point.

Q467 Lord Forsyth of Drumlean: Is it really a problem for Scottish Ministers if they go on a spending binge based on a high oil price and the revenue disappears because the oil price falls? Would the position not be rather analogous to having a large bank in your economy? To what extent would an independent Scotland be too big to fail from the point of view of the Treasury and the rest of the UK? Although you might have fiscal rules, in practice the rest of the UK Treasury would have a pretty strong interest—would it not?—in bailing out an independent Scotland if it got into financial difficulty. Should the Treasury be thinking about this problem, which, as I said, I would characterise as an independent Scotland being too big to fail? With regard to the notion that we can agree some rules with an independent Scotland and that will be fine, if they break the rules, so what, would that have not have a knock-on effect on the rest of the UK?

Lord McFall of Alcluith: Looking at paragraph 42 of your written evidence, are you not agreeing with that when you say, “The extreme volatility of North Sea Oil revenue poses a
serious problem for Scotland but none for the RUK unless Scotland approaches fiscal collapse a la Greece”. That is really the point that you are making with regard to Lord Forsyth’s point.

Professor Iain McLean: Yes, but I do not see fiscal collapse a la Greece as occurring very quickly. I see this as less of a threat—again, taking an RUK perspective—than I do the issues of financial and monetary regulation. If Scotland, having by hypothesis adopted a set of fiscal rules, then fails to observe its own fiscal rules, the first people to notice will be creditors—holders of Scottish debt. There will be an instant reaction in terms of bond yields, and that will be an instant warning to the Scottish Government that they have to do something. So possibly my paragraph 42 was a little overwrought. I do not see this as posing an immediate threat to financial stability in the rest of the UK, whereas I do see the risks associated with financial regulation as an active, live threat. I would certainly see this as being a threat to the fiscal balance of Scotland, and that will be for the Scottish Government and the Scottish people to deal with. To the extent that independence involves a grown-up discussion about balancing the books, which has not taken place in Scotland since 1707, one could say that that is perhaps the best argument for Scottish independence, but that is perhaps rather outside my brief.

Q468 Lord Rowe-Beddoe: Professor McLean, you refer in your written submission to expert academic evidence on the economic consequences of previous splits, and you specifically talk about the Republic of Ireland and Czechoslovakia. Could you summarise that evidence for us and highlight similarities and differences with the Scotland case that we might consider?

Professor Iain McLean: Yes, with pleasure. I think the headline summary is that there was acute disruption in both cases but, after a while, the situation settled down and there has been no lasting damage. In the case of Slovakia—here I am summarising Dr Henderson’s view rather than offering you my own—there was an immediate reality check. The Slovak currency was not credible at par under the then Slovak Government, which negotiated independence. A change of government in Slovakia in 1998 led to the external credit rating of Slovakia going above that of the Czech Republic and led to the sequence of events such that, for better or for worse, Slovakia is now in the eurozone and the Czech Republic is not. So I think it would be hard to say that there were long-term deleterious consequences of that particular split.

In the Irish case, we have to take a longer view and it is a rather difficult one to take, as immediately after independence the Irish economy was devastated by civil war. It was then rebuilt by the party which won the civil war—the Free Staters, as they were then. When you then had a change of government to the party which had lost the civil war—de Valera’s party—in 1933, that party took Ireland in a very autarkic, isolationist direction, where essentially it stayed for 40 or so years until the Garret FitzGerald Government in the 1980s. But I would regard that as domestic Irish policy choices. No doubt the Irish economy would have grown somewhat faster if it had not experienced the protectionist turn that was taken under de Valera. In the very long term, I do not think one can say that Ireland has either suffered or benefited compared with what would have happened counter-factually if it had remained in the UK in 1921. So I think that the long-term consequences are possibly rather small—smaller than the short-term consequences.

Q469 Lord Rowe-Beddoe: Can I go back for a moment to Czechoslovakia? You referred to it and other witnesses have told us what the intention was. I am talking about the timeframe in which it is envisaged that negotiations will take place to satisfy both sides of the
division. Some of the witnesses who have appeared before us have suggested four or five years. But in Czechoslovakia they threw all their toys out of the pram and they were away in some three months. I would assume that the consequences of the way they split have been clearly in favour of the Czech side rather than there being any form of equality between the two.

**Professor Iain McLean:** I think probably not. The split enabled the two countries to go their own ways and to run their economies in the ways which seemed to suit the Governments and the people of the two countries. After all, they are both among the most successful of the successor states to the former communist regimes in central Europe. I could give you a slightly more detailed answer but I think that, to save time, I should simply refer you to an excellent paper which Dr Henderson has written as a briefing note for the Political Studies Association, which, again, I will notify the clerks of.

**Q470 Lord Rowe-Beddoe:** Thank you. We are different from Czechoslovakia. This is RUK, so there are three distinct nations involved in the rest of the UK. Can we learn anything from Canada, which has debated such a move on many occasions, as has Catalonia in Spain? Can we learn anything from why there was hesitation to take such a move?

**Professor Iain McLean:** I have to be cautious in this answer because there are academic experts on both those territories in UK universities and I am not a specialist in either. In the Canadian case, there were the two Quebec referendums in 1980 and 1995. As has already been alluded to this afternoon, the result in 1995 was very close indeed. I think that when it was known in advance that it was likely to be very close there was some business disruption. Since then, what I have perceived just from casual observation is the same as I perceived in the Czech Republic/Slovakia case. Quebec has not in the long term suffered from the events of 1995.

As to what the Canadian federal Government did about the threat of Quebec’s secession and how they saw their way to heading it off and so on, that could be the subject of another entire afternoon’s evidence. I could come back and do it but I would rather nominate somebody who would be more expert than me.

In the case of Catalonia, it is a little hard to draw helpful analogies, one reason being that all the Spanish regions have some fiscal autonomy at present. However, none of them has as much fiscal autonomy as would accompany independence on whatever terms it was negotiated. The situation is somewhat easier for the Catalans because it is one of the richest regions of Spain, whereas Scotland is an average—Wales and Northern Ireland are poorer than average—region of the UK.

**Q471 Lord Tugendhat:** You make a number of references to Ireland, which of course is understandable because it is a part of the United Kingdom that hived off. Apart from the differences to which you have referred—the civil war and so forth—it seems to me that there is one aspect of the Irish experience which the Scots would not wish to replicate, and that is that emigration remained very high. It had been high before independence and it continued to be high. The more autarchic the de Valera Government became, the more emigration increased. To the extent that the Irish sought to differentiate themselves from the United Kingdom, their population diminished, and that is of course the reverse of what the Irish independence movement would have hoped for. I make that point not because I want to draw any parallels at all—the situation is quite different—but because it seems to me that Irish examples are really not very valid when considering the Scottish experience.
Professor Iain McLean: Ireland in 1921 was a deeply rural and underdeveloped economy. Even with the best economic policy that would have been available to any policy-maker anywhere in the world in 1921, emigration might have continued. It is probably common ground that policy mistakes were then made, notably by the de Valera Government, and not reversed for many decades until the turn to a truly open economy under the FitzGerald Government in the 1980s. So I think it would be hard to draw any analogies with Scotland, which is not an underdeveloped agricultural economy. One hopes that politicians will not make easily avoided policy mistakes after independence.

Q472 The Chairman: Could I go just go back to a point that you made in response to Lord McFall about paragraph 42 in your paper, on which I have been reflecting? We have talked in terms of robust negotiations on financial institutions and financial regulation but, in the event of extreme volatility of North Sea oil revenue, is it not likely that it is the lender of last resort issue which will really matter most in these negotiations? You say, “As negotiators will all be aware of the fiscal risk … they will have an incentive to design robust institutions”. Do you not really mean that the rest of the UK negotiators are most at risk and therefore will most insist on robust institutions?

Professor Iain McLean: That is what I intended to convey and I am sorry if I was not clear in my earlier answers on that point. I assume that the rest of the UK negotiators will, on independence day, observe that oil revenue for Scotland is three things: volatile, in predicted long-term decline, and barely adequate to make the difference between Scottish expenditure and Scottish tax revenue on independence day. Given that the rest of the UK negotiators will notice that it has all those three properties, that will incentivise them to insist on whatever firewalls they think will work to protect the rest of the UK from a Scottish collapse. That is what I intended to convey in that paragraph and I am sorry if I was not sufficiently clear in earlier answers.

Q473 Lord Forsyth of Drumlean: My difficulty with that answer and the previous discussion is that I cannot think what the firewalls would be in practice. If things go wrong in Scotland, what are they going to do about it? They will have to come to the rescue because there are so many trade and other relationships across the border. It is a bit like the position in which we found ourselves in 2008 when the major banks got into difficulty. Everybody said that the taxpayer should not bail them out but actually we did not have a choice because the system depended upon it. When you say, “whatever firewalls”, what would the firewalls be that protected us in England?

Professor Iain McLean: For this scenario, we are assuming that Scotland would have its own interest in having conservative fiscal rules. If, for any unaccountable reason, the Scottish negotiators failed to volunteer that they would adopt a very conservative set of fiscal rules, the rest of the UK negotiators and also any EU negotiations which an independent Scotland got into would do the insisting for them. So I come back to my earlier answer to you, Lord Forsyth, which is that any failure to balance the books because of declining oil receipts would be a slow-burn crisis. It would not be an instant crisis like the Slovak currency in January 1993; it would gradually become apparent that the Scottish Government were failing to balance their books, and that would have all the consequences that we all know, but I do not see that they would be instant consequences. Perhaps putting Greece in that paragraph was overheated on the grounds that one aspect of the Greek crisis arose because it was discovered that the Greeks were cooking the books, and I do not think that that would be an analogous situation in Scotland.
Q474 Lord Hollick: You mentioned at the beginning of the session that it would be highly desirable if a number of these issues were addressed before the referendum took place. I want to pursue that a little bit further. I think that we have identified, certainly on the financial side, that uncertainty would be the enemy, and markets can take their revenge quite quickly. From a practicable point of view, notwithstanding the fact that the referendum is not the moment of independence but it presages independence, is it not the case that these issues would have to be addressed pretty clearly so that financial markets knew where they were? That would require not only a declaration by the proponents of independence that they would intend to use this or that currency; it would require a degree of bilateral discussion with the United Kingdom so that in fact, at the point of the referendum, financial markets and those people voting would have a clear idea of how these very serious issues, which can undermine an independent Scotland very quickly, could be addressed.

Professor Iain McLean: I can certainly see the force of that. I understand that UK government spokesmen have said that they are not prepared to negotiate about hypotheses which may never come to reality. That, I believe, is the current stance of the UK Government, so I would hope that you would put that question to Ministers rather than to me.

Q475 Lord Forsyth of Drumlean: Related to this but turning to the issue of EU membership, which you have just touched on, the first question is: do you think that Scotland would have to reapply for EU membership? I think that the answer to that is yes. What do you think would be the main differences that would arise from a Scottish perspective as a result of joining the EU? Would, for example, the opt-outs which we enjoy on the euro and so on necessarily be lost? What is your view?

Professor Iain McLean: I have to be cautious in answering that question, Lord Forsyth, because I am not a lawyer and the question you have asked is partly a legal question. There are well-known experts in Scotland on that precise subject, such as Professor Adam Tomkins of the University of Glasgow and Professor Neil Walker of the University of Edinburgh. I hope that the Committee will ask them that precise question. Members will be aware that there was a recent House of Commons Library report which covered those issues on the legal side. So my answer to your first question as to whether it would be a matter of a separate negotiation is: probably, but do not take my word for it. My answer as a political scientist is that on the EU side a Union in trouble is not, at the end of the day, going to throw out 5 million of its existing citizens, so in the end there will be an agreement. However, I think that the likeliest sticking point is precisely the one that Lord Forsyth has just identified, which is: would Scotland get a share of the current UK rebate? I am pretty clear that the answer to that is no.

Q476 Lord Forsyth of Drumlean: What about the currency issue? My understanding of the rules is that ultimately Scotland would have to join the euro, if not necessarily immediately.

Professor Iain McLean: That is also my understanding of the rules, but it does not seem to have troubled policy-makers in Sweden for the, by now, quite substantial number of years in which that has nominally applied.

Q477 Lord Forsyth of Drumlean: But there is a more immediate issue, which is the size of the deficit that was being run by the country. Scotland’s budget, based on the current

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4 A. Thorp and G. Thompson, Scotland, Independence and the EU Standard note SN/IA/6110, Nov 2011
numbers, would seem to imply that there would have to be some reduction in public expenditure or some increase in taxation in order to meet the rules. Is that right?

Professor Iain McLean: This goes back to my earlier answer to Lord McFall. I think that a Scottish Government would have to offer the world some conservative fiscal rules, which I think would carry the implication of either more tax or less spending or both.

Q478 Lord Forsyth of Drumlean: So, everything else being equal, although Scotland would be able to join the EU, that would mean that it would have to either find some savings or increase taxation.

Professor Iain McLean: I think I would agree with that, while not claiming to be an EU expert.

Q479 Lord Forsyth of Drumlean: One other question. Do you think Scotland would be better off in the EEA?

Professor Iain McLean: I do not see that it would really make any difference. I cannot see that it would be better for Scotland. The EEA, likewise, would surely insist on conservative fiscal rules and on a credible currency. If it is in our minds that the Scottish Government might say, “Oh well, if you won’t play the game, we’ll go to the EEA instead”, I do not think that that would be seen by the European Commission or the Council of Ministers as a credible threat, so I do not think that it would make any real difference.

Q480 Lord Forsyth of Drumlean: So, to sum up without putting words in your mouth, whichever route one goes, there is going to have to be some degree of fiscal discipline.

Professor Iain McLean: If the GERS numbers for the fiscal year 2014-15 were similar to those that we have now.

Q481 Lord Forsyth of Drumlean: And, given that we have agreed that the oil price is very volatile, it would seem that the scope for domestic expenditure or for maintaining a stable tax system would be very much driven by the oil price.

Professor Iain McLean: I would agree with that, yes.

The Chairman: We have had a most interesting afternoon, Dr McLean and Mr Ingram, and thank you very much indeed for coming.

Professor Iain McLean: Thank you very much for inviting us.
Professor Malcolm Chalmers — Written evidence

The Economic Implications for the UK of Scottish Independence: A Note on Defence Aspects

The future of the UK’s armed forces, and their associated assets and liabilities, will be one of the more difficult items on the agenda of post-referendum negotiations in the event of a ‘Yes’ vote. In contrast to most other government-provided services, today’s UK armed forces are structured almost entirely around Union-wide objectives. As a consequence, the geographical location of UK defence assets (including personnel) would provide little guidance to the two parties as they sought to agree on how to divide them between the two successor states.

The division of defence assets would have to make some assumptions as to the likely foreign and security policy objectives of the two successor states. In this paper, it is assumed that Scotland would be likely to draw on the experience of neighbouring states of similar size (such as Denmark or Ireland) in shaping its post-independence military. The rUK, by contrast, is assumed to want to maintain the existing military capabilities of the UK, not least in order to minimise the reputational damage that would follow the loss of Scotland.

These differences in strategic objectives would be the key to understanding the initial negotiating objectives of the two parties in the defence field. They could also provide opportunities for trade-offs between issue areas, with (for example) an asymmetrical division of defence assets in the rUK’s favour offset by concessions in (for example) the division of the national debt. But a settlement along these lines would depend on an agreement being reached on the continuing basing of rUK naval and air forces in Scotland after separation.

How much do Scotland and rUK currently spend on defence?

Estimates of spending and revenue produced by the Government of Scotland notionally allocate non-geographically-identifiable spending between Scotland and the rest of the UK. Around 60% of spending in this category is in defence. On this basis, £3.3 billion is Scotland’s 2010/11 contribution to the funding of total UK defence spending, allocated in proportion to population share. The rUK share is £35 billion.

Spending Levels after Separation

Likely differences in wider security policy mean that the disparity in defence spending levels between the two successor states would probably be greater than this disparity in notional contributions. As has been argued by the author in more detail elsewhere, the politically acceptable level of defence spending in an independent Scotland is more likely to resemble that of comparably-sized NATO member states (such as Denmark and Norway) than that of the UK (now the only NATO-European country, with the temporary exception of Greece, spending more than 2% of its GDP on defence). An independent Scotland’s annual defence budget, as a result, seems unlikely to exceed 1.4% of GDP, or around £2 billion (at 2011/12

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It may even be significantly less, were Scotland to follow the low-spending route followed by Ireland, which is similarly protected by geography from external military threats, or newly-created states (such as Lithuania and Latvia) which have sought to create armed forces from scratch. These three countries spend, respectively, 0.6%, 0.8% and 1.0% of their GDP on defence.

An independent Scotland could therefore expect to ‘save’ at least £1 billion in its annual defence outlay, compared to its current contribution to the UK defence budget. It might be more vulnerable to external threats than it is at present, especially if these develop in ways that are currently unforeseen. As with other small West European states, however, the new state’s security from external threat would depend more on its ability to draw on the capabilities of more powerful allies than on its own capabilities.

The rUK, by contrast, would not be starting with a blank sheet of paper. Faced with the damage to the UK’s international reputation as a result of Scotland’s departure, its leaders would be likely to place a high premium on being able to demonstrate that it remains a major military power. The UK may already be struggling to maintain a broad spectrum of high-end capabilities. But Scottish independence could (at least initially) make it more politically sensitive to launch a new round of capability reductions.

Scottish independence, however, would not substantially reduce the tasks that the UK armed forces are asked to fulfil. Because their capabilities are now largely optimised for expeditionary operations, a reduction in territorial defence requirements will make little difference to defence requirements. Nor could the rUK assume that Scotland’s forces would always be available for use alongside its own. In order for the rUK to maintain military capabilities for power projection comparable to those that the UK would have had, therefore, it will have to maintain a defence budget at a comparable level. Total post-breakup defence spending by the two successor states, therefore, would be likely to be greater than that previously being spent on Union armed forces.

Whether the rUK could afford to maintain the UK defence budget would depend on the wider economic context created by separation. The proportion of GDP devoted to defence would rise somewhat compared to the pre-independence situation. But the rise would be relatively small, perhaps amounting to around 0.2% of rUK GDP. Other elements in the balance of fiscal advantage – such as the end of Scotland’s spending bonus as a result of the Barnett formula, and/or decisions on the allocation of hydrocarbons revenue - would be proportionately more significant.

**Division of Assets**

A transition period would be needed to carry out the separation process, dividing assets and liabilities, amending procurement and personnel contracts, and relocating equipment and stores.

As of 31 March 2011, total UK MoD net assets (assets less liabilities) totalled £106.6 billion. Divided strictly on the basis of population share, an independent Scotland would be entitled to 8.37% of these assets, valued at £8.9 billion.

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7 The defence policy statement issued by the SNP in 2012 proposes an annual ‘defence and security budget’ of £2.6 billion. Adjusted for the exclusion of ‘security spending’ of around £200 million per annum (Scotland’s notional share of £2.4 billion UK annual spending on the Single Intelligence Account) and inflation, this amounts to around £2.1 billion at 2011/12 prices.
Yet Scotland is unlikely to require such a high share of defence assets for its own defence requirements. If its initial defence budget were to be set at £2bn (at 2011/12 prices), this would amount to only 5.0% of combined defence spending. Moreover, faced with a choice of inheriting a small number of pieces of kit that are over-engineered for Scotland’s more limited defence purposes, or taking a cash equivalent for reinvestment in a ‘clean slate’ force, Scotland’s defence planners might decide that the latter had much to commend it.

The rUK would face pressures in the other direction. If, as is assumed above, the rUK were to seek to maintain a defence capability comparable to that of the UK, it would be likely to want significantly more than the 91.6% of total assets which strict population share would suggest. It would, moreover, want to keep almost all existing inventory of major high-value equipment. It would be hard, for example, to imagine Scotland wanting (or the rUK being prepared to give up) Type 45 destroyers, nuclear powered submarines, amphibious and carrier ships, or F-35 aircraft. Pressure for the rUK to take 95% or more of total defence assets might be increased by the concentration of defence infrastructure in England.

If Scotland were to take only 5% of total MoD net assets, it could argue that it was entitled to financial compensation (amounting to some £3.6 billion) in return for receiving less than its population share. Demands for such compensation would have to be part of a wider, and complex, negotiation on the division of UK assets and liabilities. Scotland’s reduced share in defence assets could, for example, provide it with a bargaining chip if it decided to seek a reduction in its share of the inherited national debt.

The rUK could argue, for its part, that it would be entitled to compensation for any additional defence spending which it had to incur as a result of a separation that it did not seek. In this scenario, the level of compensation that the rUK MoD could claim would, in large measure, depend on how far a new Scottish Government insisted on the rapid removal of rUK forces (inherited from the UK) from its territory. In particular, it can be assumed that all the submarines currently based on Clyde, together with most of the conventional forces deployed there for their protection, would become part of the rUK military after separation. Most of the RAF aircraft currently based in Scotland (and soon to be concentrated in Lossiemouth) would probably also transfer to the rUK’s RAF. If Scotland were to insist on these units being relocated to the rest of the UK, the rUK could argue that the costs of such a move should be funded by Scotland (perhaps offsetting some of the ‘asset dividend’ set out above).

By contrast, if most Royal Navy and RAF units based in Scotland were to remain there under rUK control, the rUK could not reasonably claim compensation. Were their bases now to become the property of the Scottish Government, the latter might feel entitled to charge an economic rent for the property being used. Alternatively, the two parties might prefer to keep these facilities (including the infrastructure at Faslane and Coulport that supports the UK nuclear force) under rUK ownership. Were this to be the arrangement, Scotland’s compensation might instead be subsumed within the wider calculus of how UK assets and liabilities are divided.

Table 1: Possible Outcome of Separation on Defence Budgets and Assets (based on 2011/12 levels)

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<th>2011/12</th>
<th>Actual UK</th>
<th>Notional Scotland</th>
<th>Notional rUK</th>
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Defence Spending:

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<th>Description</th>
<th>UK</th>
<th>Scotland</th>
<th>Total</th>
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<td>Population Share</td>
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<td>£3.2 billion</td>
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Defence Spending: Estimated Defence Requirements

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<th>Scotland</th>
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<td>£38 billion</td>
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Defence Assets:

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<th>Description</th>
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<tr>
<td>Population Share</td>
<td>£107 billion</td>
<td>£8.9 billion</td>
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Defence Assets: Estimated Defence Requirements

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<th>Description</th>
<th>UK</th>
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<td>£107 billion</td>
<td>£5.3 billion</td>
<td>£101.7 billion</td>
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8 October 2012

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8 This assumes that the rUK seeks to maintain the current UK level of defence spending, and that Scotland spends around the same proportion of GDP on defence as Denmark and Norway. Under this scenario, the total amount spent on defence in the two states therefore exceeds the amount that would have been spent if the UK had remained as a single state.


10 Assets divided in proportion to post-separation defence budgets.
TUESDAY 26 JUNE 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord Rowe-Beddoe
Lord Shipley
Lord Tugendhat

Examination of Witnesses

John Cridland, Director General, Confederation of British Industry; Graeme Leach, Chief Economist and Director of Policy, Institute of Directors; and Simon Walker, Director General, Institute of Directors.

Q279 The Chairman: Mr Cridland, Mr Walker and Mr Leach: thank you very much for coming. We have had a few internal matters to deal with so I am sorry that we are starting a little late. You will have seen earlier this week the launch announced of Better Together, under the chairmanship of Alistair Darling—and off it goes. Our inquiry does not take a position on the politics or the constitutional situation of Scottish independence. We are concentrating on the economic implications for both Scotland and the rest of the United Kingdom. We very much hope that our inquiry will help to inform the debate that has now been launched. One very important aspect of it of course is the implications for the business community, CBI and others such as the IoD. We are very grateful to you for coming. I will begin with the broad question: what is the attitude of your members to Scottish independence? There are issues of whether it will affect their decisions about where to locate their businesses or to move. There are issues of migration of companies or financial institutions in either direction. There are a whole range of issues. Could we start by getting a broad-brush response from you on that?
John Cridland: Thank you, Lord Chairman. I very much welcome the inquiry and its terms of reference and perspective. Of course, British business respects the fact that it will ultimately be the voter who will make a decision on this issue, but the business implications are significant and business has clear and determined views. From a British business perspective, as well as a Scottish one, we put great emphasis on the importance of the single market. The single market is a key UK asset and the certainty and level playing field of rules on tax, law and regulation adds to economic growth. Given that we have had the benefit of the single market for a very long period, it is hard to quantify those benefits. One can use at least partly the analogy of the more recent development of the European single market and the benefit that it has brought in terms of economic growth and job creation to see what we might lose by fragmentation—we feel inevitably that if there were two independent countries in this one island there would be a fragmentation of the single market. One should not speculate how far and how significant—that is a matter for the future—but in our judgment there would be an economic loss. For that reason, we have taken the view that we cannot see an economic benefit to the UK business community or the Scottish business community as a whole from independence. For that reason, we favour the retention of the union. Clearly there will be individual CBI member companies who will take a different approach, as is the prerogative. We form a view on the basis of our mandating processes and our view is we would favour the retention of the union.

Simon Walker: Thank you again for letting us give evidence. We do not have survey evidence from our membership so I cannot give a precise figure for the proportion of our membership for and against independence. Through my conversations with businesses up and down the country, including the many IoD members in Scotland, and particularly at our convention at the end of last year and my conversations with the IoD’s regional chairs and directors, I feel that business opinion among my members is split similarly to the rest of the population. A number of members are ambivalent about change, some have strong opinions both for and against it but there is no uniformity of view. Our view has been to not take a position but to say that we believe there is great ingenuity and flexibility in Scottish industry and business. We believe that whatever constitutional arrangements are arrived at would be a situation that business would be able to work with.

Graeme Leach: I would only add that this requires specific questions to business as to what they think independence means. Different people have different visions of what an independent Scotland might look like. Without some very precise and probing questioning as to what they envisage, it is very difficult at this stage to be clear about what our membership think.

Q280 The Chairman: What sort of probing questions?

Graeme Leach: For example, what their vision is of the size of the state, what they assume regarding public spending and taxation. That has ramifications for the ensuing economic model. People obviously have very wide differences in views here. It is about what assumptions you are making when you talk about an independent Scotland, before you actually ask that question.

Q281 Lord Lawson of Blaby: May I ask Mr Cridland a supplementary? He spoke exclusively about the single market. It is pretty clear that if Alex Salmond was in the room, he would say that of course the single market would be retained. Not only are we part of the European single market, and he wishes an independent Scotland to remain in the European Union, but I am sure he would not wish to break up the single market that exists between Scotland and the rest of the United Kingdom. If that is so, are you saying that it
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does not make any difference one way or the other to your members? Is that the only issue—that so long as the single market is retained, there is nothing else to worry about?

**John Cridland:** No, I am certainly not saying that. I agree with my colleagues from the IoD that there are more questions than answers at the moment. There are a series of imponderables and we are looking forward. The position of business in Scotland would, I am sure, be influenced by the attitude of a future Scottish Government if it was in an independent country and by whether it was pro-business or took a more statist view, in the way that Mr Leach has already identified. I concentrated on the single market because I think it is the one thing that we can be clearer would lead to some fragmentation. We have already seen a limited degree of fragmentation of the UK single market as a result of devolution. I should be clear that I am defining the single market broadly. I described it as the framework of legislation, regulation and taxation within which business operates. Clearly an optimal single market is one where there is very limited variation of those rules, such that companies do not have the additional costs of compliance due to operating with different systems in different parts of one market. There is already limited fragmentation. A reasonable hypothesis would be that if there were two completely separate Governments in the one island, their policies would diverge over time. To take a particular example, which on my wider definition of the single market is very relevant—arguments are being made in at least two of the devolved Administrations, as we speak, for the devolution of corporation tax. I think that would be damaging to the single market. It is in the interests of the UK economy to have a single approach to corporation tax.

Those were the aspects I was alluding to. Clearly, going forward, it depends just how much fragmentation, which depends on a whole range of factors that we may come back to with subsequent questions. A lot depends on the currency arrangements—whether there is a single pound across the United Kingdom or across two separate countries within this island, whether one country has an English pound and the other has a Scottish pound, or whether one country has the pound and the other has the euro. That would inevitably lead to a fragmentation of the single market. If you did have separate currencies, you would have all of the implications of currency hedging.

**Q282 Lord Forsyth of Drumlean:** To what extent do you feel that your members are going to keep their heads down on this issue because they are concerned about the security of their business and perhaps feel under pressure from the Scottish Government? The example that comes to mind is of Lord Wallace of Tankerness, a distinguished member of the Government who was invited to speak at the 25th anniversary dinner of Loganair, only to find that the invitation was withdrawn by the company following representations from the Scottish Government. To what extent is business feeling a little inhibited in the current environment from speaking out on these issues? I sense a certain amount of hedging in your answers.

**Simon Walker:** I would acknowledge hedging. In the case of the IoD, it is because when I talk to our members in Scotland, they are generally quite divided on the issue. I found a lot of strong feeling both ways, as I would have expected. I am thinking back to the IoD conference in December: it was pretty narrowly divided. The Scottish Finance Minister was speaking there. There was certainly quite a lot of sympathy for the points that he raised, as well as significant opposition. We are asking a lot of questions because we feel there are questions that need to be explored, rather than taking a position, because our membership is genuinely split on the issue.
John Cridland: As you know, the CBI is studiously non-party political. That is an article of faith for the CBI. We work with any democratically elected politicians. CBI members in Scotland at the front end of this have asked a series of questions of the SNP Government on the economic implications of independence, and it is on the basis of assessing the answers to those questions that they have concluded—not unanimously; I respect the fact that there are CBI members in Scotland who would favour independence, but by a majority—that they cannot see the economic benefits of independence on the case that has been made so far. However, companies operate within a democratic mandate from society and you would not expect companies to engage in political debate that could be damaging to their business situation. In a sense, that is the role that they expect representative organisations to play.

Q283 Lord Forsyth of Drumlean: You have not had any suggestions from your members that they might be disadvantaged in carrying out their business if they took a particular stand in opposition to what is a very dominant Government?

John Cridland: These issues have come to the fore very rapidly and, one might argue, somewhat unexpectedly. I am conscious that boards of a number of my member companies in Scotland are assessing the situation. One of the challenges that I am sure you have in this inquiry—I certainly had it in preparing for it, my Lord—is that there is currently very little economic evidence. We are at the beginning of a journey. Companies are assessing, at a time when there is uncertainty—the one thing that characterises the business community on the questions you have asked me is that they do not know all the answers—and they will not tend to volunteer a view. They are keeping their peace. But the CBI Scotland council is an elected body that represents the CBI in Scotland and it has taken the view that it is in favour of the union, and that is the representative view of the CBI.

Q284 The Chairman: You are obviously suggesting it is still pretty early days but it is entirely to try to work through the tangle of all these different issues that our inquiry has been set up. From what you have seen so far, do any particular business sectors have great concerns? For example, in the financial community, the location of head offices and so on could be an issue, with not only tax but currency matters, as you suggest, and financial regulation could be dominant in their minds. Is there any indication yet of particular sectors that are concerned?

John Cridland: Given the level of uncertainty, I have not picked up a sectoral pattern, but I echo and support your comment about financial services. A lot of the debate is taking place, rightly, in Scottish financial services because it is so important to the Scottish economy. The evidence shows that Edinburgh as a place for financial services is not as well positioned in 2012 as it was in 2007, and that is simply a consequence of the financial crisis that resulted from the subprime housing crisis in the United States. There are very legitimate concerns. As we know, business location decisions and business investment decisions are taken for a range of reasons. They are always taken by boards on the basis of shareholder return, looking at a cocktail of factors. It is very difficult at this point to give you any clear answer as to whether I have member companies who would take different investment decisions if there was an independent Scotland. They are looking at these issues and they are expressing levels of concern to me, but the unknown question here is: in an independent Scotland, would a separate Scottish Government be more or less pro-enterprise? The answer to that would only be known over time, and that would be the most likely factor to affect investment decisions in the medium term. Are they in favour of a bigger state or a smaller state? Are they in favour of higher taxation or lower taxation? Do they exacerbate the fragmentation of the single market or do they seek wherever possible to give Scottish and
English business the benefits of cross-border trade without unnecessary barriers? We can but speculate.

Q285 Lord Tugendhat: Mr Cridland, both you and Mr Walker are answering in a very considered and well thought-out fashion. We were very struck last week when we had some evidence from people in the north of England when they said that actually nobody in the north of England was thinking about this at all. To what extent do the very considered replies that the three of you are giving reflect a considered view on this issue, at any rate of south of the border business? Is the business community in England, Wales and Northern Ireland considering these issues at all? I am sure it is in Scotland. Or is it something that you and the CBI are considering on behalf of and in readiness for your flock, which might subsequently catch up?

John Cridland: Clearly I represent a UK-based organisation. In the time I have worked at the CBI, the geography of companies has become much less distinctive. I represent the Confederation of British Industry but a large proportion of my member companies are now trading internationally and may well have corporate structures and shareholder bases that are international. It is quite difficult for me to think of English companies, Scottish companies, Welsh companies or Northern Irish companies. They are increasingly global businesses and that is how they address it. Therefore, I will answer your question in two ways. First, those closer to the politics of Scotland, who are living with these issues through Scottish politics and the Scottish media day by day, clearly have needed to think about these issues more than those in the deep south-east of England. But actually, some of the companies I talk to most often are, for example, companies in the retail sector that are evenly spread across the whole United Kingdom and therefore, while never considering themselves Scottish businesses, they have a very considerable footprint in Scotland because they have a considerable footprint evenly spread across the whole country. Most of those companies are asking and contemplating these questions, and will look with very great interest to the report that this Committee produces. There is a lot of scratching of heads and when they look at academic research and commission consultants to give them economic analysis, there is not much to rely on at this time.

Taking the issue that I touched on briefly a moment ago—corporation tax—that initially came up as a question of devolution in relation in Northern Ireland. Then it became an issue of devolution in relation to Scotland. More recently, the question has been raised in relation to Wales. Companies UK-wide and companies in our national council—not necessarily English companies because, as I have said, I am not sure quite how I would define them, but companies that are looking at it from a UK perspective rather than a devolved perspective—have been equally passionate that the single market would be damaged, even if they are not looking at it from a Scottish or Northern Irish perspective. The lead analysis is coming from those most directly affected, but actually all companies are affected. Any company that does business in Scotland, even if it does not have a branch operation there, would be affected. Therefore, it is a legitimate issue for all to be concerned by.

Simon Walker: We have a slightly different perspective on this, which probably reflects our slightly different membership, with a much greater dominance of small and medium-sized businesses in the IoD. Although our Scottish membership has debated this at length and is well informed and very keenly argues the toss about this, the membership in the rest of the UK does not particularly. It is not a hot issue or something that people are deeply concerned about. Opinions that I have heard expressed have been about the desirability of competition, particularly tax competition. Alex Salmond spoke at our convention earlier this year and certainly appeared to be holding out the promise of lower corporation tax and
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efforts to attract business to Scotland. Unsurprisingly, our members in England found that rather attractive and would consider that a good thing in principle. We have been campaigning on these things for some time. I do not think there is strong feeling within the IoD south of the border. We see it primarily as a political rather than economic issue. Where there has been concern, it has been of that sort.

Q286 Lord Hollick: Mr Walker, when you talk to your members north of the border, apart from tax, which you have just cited, what other issues are at the top of their minds when they say that they are in favour, do not know or are against?

Simon Walker: This being the IoD, there is a concern about levels of government spending and some suspicion of what an independent Scottish Government would end up spending on, for example, social services and how all this might translate under an independent Government. There is suspicion and concern about those issues. I do not think there is a view that a Scottish Government would be hostile to business. Reflecting on my last role at the British Venture Capital Association, the Scottish Government appeared to make quite strong efforts to encourage venture capital activity in Scotland, as well as high-tech and other knowledge-based industries, so there was some recognition of that. I suppose that sums it up overall. They see it primarily as a political rather than economic matter.

Graeme Leach: There is also a business concern that the current Scottish economic model might be seen as an easy one to run in the future. But the Nordic example, does not show that a large state can be run in parallel with strong growth. We have done a lot of work in this area. The reason the Nordics have been able to manage faster growth in recent decades has been the shrinkage in the state, with the Swedes cutting the state by 20% of GDP. Our members have a concern that people can look to the Nordics and say, “You do not need to worry about the size of the state”, whereas we would say that the reason the Nordics have achieved growth acceleration in recent decades is because they have shrunk the state. The debate is almost in terms of where the Nordic economies were 20 years ago, not where they are now.

Q287 Lord Levene of Portsoken: Mr Cridland, you said earlier that the national businesses in the retail sector had coverage throughout the country both in England and Scotland, but before that you were talking about the financial sector and the fact that there are businesses that are disproportionately large in Scotland because that is the way that things have grown up historically, with a strong financial sector in Edinburgh in particular. Do you get the feeling that in the event of Scottish independence those businesses in the financial sector might tend to push more of their business out of Scotland into England?

John Cridland: It would be too strong to say that that is a feeling that is coming through, my Lord. The debate is taking place. Echoing the points I made earlier to Lord Shipley, over time there has been a loosening of the sense of whether a bank is a Scottish bank or a London bank. The Royal Bank of Scotland is a very telling example. What is clear in the financial sector is that people want to consider the implications of what happened in 2008-09 and think about how that would have played out if we had been two independent nations in one island. If the Scottish Government had needed to come to the rescue of the Royal Bank of Scotland in 2008-09 in the way that the UK Government needed to, that £45 billion—from memory—of taxpayer support would have been 37% of Scottish GDP, rather than 3% of UK GDP. So it is inconceivable that a Scottish Government could have provided the support necessary. There are many issues that are not strictly business issues in the narrow sense of the word but are fiscal and monetary policy issues where there are so many unanswered questions as to how two independent Governments would operate in a very integrated
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economy—whose responsibility it would be to support which institutions with which proportions. In the financial services sector, which is so integrated, those questions are very difficult to resolve.

Q288 Lord Levene of Portsoken: Do you think, in the example you gave of RBS, that might come as a rude wake-up call when people start to think the whole thing through logically? How could an international institution of that size be supported by what would actually be a pretty small Government?

John Cridland: After all, as I understand it, it is UK Government policy that never again must the United Kingdom have to bear the full cost of our overweighing—very good overweighing—in international banking on its own balance sheet. Therefore, if one looks at the implications for Scotland, these are very significant issues. These are the sorts of questions that need to be debated from a business perspective in this inquiry and as we move towards 2014 because I am not sure that there are many members of the public who are as yet fully aware of the implications. I do not think the implications for financial services are positive; they are probably negative.

Q289 The Chairman: Is there not an issue in relation to RBS and others as to where their headquarters would be?

John Cridland: Indeed.

Q290 The Chairman: That would obviously affect many of the things you are talking about, including taxation.

John Cridland: Just so, and it is difficult to speculate on that.

Graeme Leach: If I can say one thing with regard to the last question. If you look at the—sorry, my mind has gone blank; come back to me in a minute.

Q291 Lord Forsyth of Drumlean: I think what Mr Leach was probably going to say is that we know what the position is with the Royal Bank of Scotland because the chairman or the chief executive—I cannot remember which—has said that it would be very difficult for the Royal Bank of Scotland to be headquartered in Scotland given the size of the bank relative to the balance sheet of the economy. The Governor of the Bank of England has said that one of the problems that we have relative to the US in the argument for separating investment banking from commercial banking is the size of the banks’ balance sheets. It would not be possible for a bank such as the Royal Bank of Scotland to be headquartered in Scotland because it would find it very difficult to raise its funds. I am surprised that your membership is not more concerned about that. Clearly, having to move businesses of that size would have all kinds of implications, for small businesses as well as large businesses.

John Cridland: My membership is concerned. Clearly it is for individual companies to make their own announcements, not for me to do on their behalf.

Graeme Leach: It is not just the legacy of the original financial crisis that is the issue with the potential fallout re RBS or whatever, there is a contemporary issue for business in the euro crisis. The fundamental question at the heart of the current euro crisis is: what do you do when you do not control the currency in which you issue your debt? The ramifications of that for an independent Scotland are right up there in members’ concerns. The problem, which relates back to the previous point about the awareness, concentration and focus of business on this issue, is that companies overwhelmingly concentrate on their own markets and their own market issues; they probably deal with only one geopolitical issue at a time.
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They have got the euro crisis to deal with, but that is not to say that they are ignoring the Scottish issue or that it will not become an even bigger issue over time. A year from now we could potentially be responding to your questions in a different manner.

Q292 Lord Forsyth of Drumlean: Mr Walker, you mentioned that Alex Salmond had come to your conference and offered the prospect of lower corporation tax. What are your members saying about the current proposals by the Scottish Government under the new tax-raising powers in the Scotland Act to put up stamp duty to 10%? How is that consistent with this view of small countries being able to use tax policy in order to create competition? Are you getting any representations about that?

Simon Walker: I have not had representations but there is certainly a suspicion around these promises. I understand that entirely. I do not think anyone is taking this at face value. On the other hand, we have been campaigning for this for some time and have been much struck by the impact on Ireland of its attractiveness to international businesses. The idea of politicians from neighbouring countries competing with each other to offer more rather than less attractive business environments is one that I am not surprised to see our members interested in. I do not think they are assuming that what is being offered is necessarily going to happen. The point you make is entirely valid.

Q293 Lord Shipley: Mr Cridland, you said earlier that your members would want to know the detail of what independence meant before 2014. It was put to us in a previous hearing that that would not be necessary, that you take a decision in principle from a referendum and then negotiations take place afterwards between the prospective independent Scotland and the United Kingdom Government. Do you oppose that perspective or do you think it is essential to understand what independence means before anyone casts a vote?

John Cridland: If I was to put myself in the shoes of the voter, I would want to be as informed as possible about the implications of the vote I was about to cast. There is a huge responsibility to understand the full implications of a vote in favour of independence. For example, what is the SNP’s position in relation to membership of the European Union, the eurozone and the Schengen area? Does it wish to retain links with the United Kingdom and have a single currency area of pound sterling? If so, does it accept the authority of the Bank of England Monetary Policy Committee to set interest rates that may reflect the 91% that is in the UK rather than the 8% or so in Scotland? If we were to offer the protection of pound sterling to an independent Scotland, would it accept that in return London would expect a fiscal and monetary pact? We know the consequences of having a single currency in separate jurisdictions if there is not some commonality. These are all perfectly legitimate questions that we need to know the answers to before we ask the Scottish voter to cast their opinion, because they affect the nature of independence.

Again, in this globalised world, independence does not mean what it once did. You could imagine an independent Scotland that, in answering some of the questions I have just posed, actually ended up with rather limited fiscal and monetary independence by choice because it wished to associate itself with a bigger economic area. It absolutely shapes the nature of Scottish independence. From a business point of view, these are the questions that would ultimately determine the investment decisions that the Lord Chairman was asking me to pontificate on. Ultimately, business would need to know whether an independent Scotland was going to be very different from the rest of the United Kingdom or actually remarkably similar.
The Chairman: Would you have a concern if the referendum took place and a lot of these questions had not been explored properly or answered?

John Cridland: Yes, I would. If I was speaking directly for the Scottish council of the CBI, these are precisely the sorts of questions that CBI Scotland has been raising in a totally objective way and seeking answers to.

Lord Levene of Portsoken: I do not want to belabour the point, but just coming back to financial services, we were talking about the views that the largest businesses there might hold if they felt that they were no longer under the UK umbrella. That is one side of the argument. The other side is: what would their customers think? I travel abroad a great deal and in countries like Mexico or China you suddenly see an RBS pop up. The local business communities regard RBS as a large British bank, with all the pluses and minuses of that. I do not think many of them will have drilled down to consider that this may not actually be a large British bank any more, it is now a large Scottish bank, and the possibility of ending up with a situation like in Iceland. Are you hearing at all that the customers of these businesses, particularly in the financial sector, would start to worry if they felt that their individual institution was no longer backed by a much larger country such the UK rather than a much smaller one such as Scotland?

John Cridland: I have not heard those views expressed yet by customers, but I hear the debate beginning to generate momentum. It is not unreasonable that we may reach that point but I have not had that view expressed to me yet.

The Chairman: The financial compensation scheme might occur to customers. Lord Lawson.

Lord Lawson of Blaby: I have two questions. First, following on from what you have just been saying, Mr Cridland, I quite understand why you and your members would like to know all the terms and conditions and particulars of a divorce, but the evidence we have received suggests that that is not going to happen. Indeed, if I may use the metaphor of a divorce, it is customarily the case that when partners in a marriage decide to divorce, the decision is taken then and there is a lot of negotiation afterwards about the financial settlement and other arrangements. So you are not going to know. Some of these things are going to be matters for negotiation. Some will be between the United Kingdom and Scotland if the referendum goes in favour of independence; others will be dependent on what an independent Scotland decides to do, and it is not going to show its cards in advance. Given that you are not going to know, what are you going to do about it?

My second question is perhaps less pointed or urgent. Assuming the separation of the English and Welsh economies, the structures of the English economy and the Scottish economy are rather different, not so much in the case of financial services, where both are heavily dependent on financial services, but it is quite clear, for example, that the Scottish economy is more heavily dependent on oil and gas and has a much larger public sector proportionately than the rest of the United Kingdom. Mr Walker pointed to the happy prospect of Scotland having lower taxation and higher public expenditure, so quite how that would play out is a question. Leaving that aside, there are these differences in structure. In the event of independence, do you think there would tend to be greater divergence or a degree of convergence, and does it matter?

John Cridland: In answer to the first question, my own view is that the onus is on those who are proposing the divorce to explain their reasons. The fact that many of these questions remain unanswered is why the CBI has a decided view—not an ambivalent view—
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that it would be better to retain the union. For the CBI to change its position, those questions would need answering in a way that we perceived was beneficial to the citizen and the economy. At the moment we do not see those answers.

In relation to the second question, it is quite difficult to think through how a future Scotland would look. This would take many years to evolve. I am struck by the fact that Scotland has nearly 24% public sector employment while England has 19% and that it spends 45.5% of GDP on public spending while England spends 41%. I am struck by some other inherent weaknesses in the Scottish economy. It has the smallest number of enterprises per head of population of any part of the United Kingdom: 673 per 10,000 Scottish citizens compared to 927 in England. There are many other statistics we could share. Scotland has a larger emphasis on the public sector and a somewhat weaker private sector seedbed. But if you divided the economy and national debt on a per capita basis, Scotland would inherit £86 billion of public debt, which on a per capita basis would be about 70% of Scottish GDP; it would run a current account deficit of in excess of 11% of GDP, so an independent Scottish Government would face some early decisions on the balance between taxation and spending.

I have no doubt that there would be aspirations to have a distinctively low-tax pro-enterprise economy, and small countries are often more agile and nimble in being able to deliver that than larger economies. But faced by some of the statistics I have just cited, Scotland would need to run a balanced budget and it would have limited fiscal means to do so without increasing taxation, particularly given some of the consequences of whatever choices it made on the level of fiscal and monetary independence that it wished to maintain. As I mentioned earlier, an independent Scottish currency would face challenges in the borrowing markets. If Scotland wished to be part of a bigger currency union, be it sterling or the euro, it would take on some responsibilities of running a balanced budget as a consequence of that partnership with other countries. It is genuinely difficult to speculate, and I am not suggesting that the climate would become inevitably less pro-business, but these are the searching questions that I think an independent Scottish Government would need to answer if they wished to convince the Scottish voter that they could strengthen Scottish living standards.

Q297 Lord Tugendhat: Mr Cridland, you have produced some extremely interesting figures and clearly the CBI has been thinking a lot about this. You demonstrated with facts and figures the degree to which the Scottish economy differs from the English economy. We also know that Scottish politics differs in many ways from English politics: on the whole, the Labour Party does better in Scotland than it does here; Scotland inclines more to the left than England does. In the light of those two factors, do you notice any difference of approach towards economic, business and social issues on the part of your Scottish membership as distinct from your membership in the rest of the United Kingdom? On the whole, does your Scottish membership—and the same would apply in the IoD—hold a somewhat different view about business, economic, social and trade union issues from that of the generality of your members?

John Cridland: No, I do not think they do. The views of entrepreneurs tend to be pretty cohesive. In my experience of the CBI, there are not many issues where the business community finds itself divided by either geography or philosophy. Perhaps in recent years the euro is one issue that has clearly differentiated different parts of the business community, but if I go to the CBI Scotland council I would not get a distinctly different view on economic, business or entrepreneurial policy than I would from the London council of the CBI. The experience of devolution is that businesses adapt to changing political circumstances. They clearly work with the Government of the day. They continue to make
their arguments about what is good for the Scottish economy or the Welsh economy, and they make those arguments to whoever is in power. I made the point earlier that you would find CBI member companies that would say that being able to work with a Government closer to the locality has certainly benefits. I have emphasised what I think might be the disbenefits, but it is clear that devolution in Scotland has been a mixed record in economic terms. There are examples where CBI Scotland would congratulate the Scottish Administration over the full period for some of the things they have achieved; there would be areas where it thinks that fragmentation of the single market has been detrimental rather than necessary. But I would not see a distinctively different entrepreneurial viewpoint.

**Simon Walker:** I think the same is true of our membership. There are not marked differences between attitudes north and south of the border. Our membership is deeply sceptical about the size of the state and government spending, and I would not want to imply that I can see how maintaining very heavy levels of public spending in an independent Scotland and still promising tax cuts can be done. I am not saying that I can see how that circle can be squared. I would not want your Lordships to think that I was taking that view. What I am saying is that our members have noted that there is an offer of competition in these areas and inevitably they find that attractive. My suspicion is that the disciplines that that situation would impose on a Scottish state, if it was actually accountable for how money was raised as well as how it was spent, would involve considerable changes in behaviour. At the moment, all the incentives seem to be about how it is spent without having any accountability for how it is raised.

**Q298 Lord Forsyth of Drumlean:** Just on that point, Mr Cridland, in your excellent answer, you gave us a number of numbers. You suggested that whether it was remaining in sterling or joining the euro or having a Scottish groat or whatever it was, there would be difficulties with those numbers. To distil this down to one sentence, were you saying that there will either have to be cuts in public expenditure or increases in taxes in order to run the currency, whether it is the euro, groat or pound?

**John Cridland:** Perhaps I might come back to the divorce analogy. Divorces are painful and expensive. All the experience we have is that there is an immediate short-term cost. That we do know; it is inevitable. I was looking at the experience of the Czechoslovakian state in 1994 where, if my memory serves me right, there was a 1% reduction in GDP for the Czech Republic and a 4% reduction in GDP for Slovakia—in that single year; it subsequently recovered—and that the ambition to maintain a single currency for a six-month transitional period failed, they had to scrub it after six weeks, because of the capital flows from Slovakia to the Czech Republic. So that immediate short-term impact is one thing we can be certain about but, as I have emphasised, it is a short-term impact, not necessarily a permanent one. In terms of the longer-term impact, I am particularly troubled by these currency decisions that need to be made, because they set a framework for fiscal and monetary policy that has major implications for both a potential future Scottish Government and a potential future remainder of the United Kingdom Government. Those decisions, certainly as taken in Scotland, on any of the scenarios I outlined, would undoubtedly be challenges and would bring implications for the Scottish Government that would involve either borrowing, taxation or reductions in spending, which I think it is important the Scottish voter is aware of before 2014.

**Q299 Lord Forsyth of Drumlean:** Just to press you on that, we are talking about either increasing taxes, cutting spending or increasing borrowing, but because of the circumstances of the balance sheet, that borrowing is likely to be more expensive?
John Cridland: As Lord Lawson said, we do not know the elements of the package that will be negotiated subsequently. Therefore, I cannot give you an absolute answer to that, but that scenario seems likely to the CBI.

Q300 Lord Lawson of Blaby: On the currency question, Mr Cridland, the current policy of Mr Salmond is that Scotland should continue to use the pound sterling. Earlier he was in favour of the euro. For reasons that will not escape any of us in this room, that is not so popular nowadays. Is it not curious, as indeed my successor but five, Alistair Darling, pointed out over the weekend, that since we know from the sad experience of the eurozone—and most people should have known before—that a single currency cannot work without a political union, to say that you will break up a political union but then adopt a currency arrangement that can only work if there is a political union? Do you think some of your members may be puzzled by that?

John Cridland: Yes, we are puzzled by that.

Q301 Lord Forsyth of Drumlean: Just to go back to the point about the broad numbers, where you set out the overall agenda, I have spent most of my life arguing against independence on the basis that it would result in Scotland not having a balanced budget. Recently that has become a more difficult argument to put because the oil price was up at $120 when all this started; I think it is now down to about $90. One of the points you made is that Scotland produces so few small businesses, which remains a puzzle. If I was a nationalist I would be saying that there would be so much enthusiasm that this would release energy and we would have more small businesses and would catch up with the rest of the UK. Do you think that independence would make it easier for people to start up and generate new businesses? Particularly, could you deal with the volatility that will result from being so dependent on the price of oil? That would be a new factor, given the proportion of the oil revenues that are relevant to Scotland as opposed to the whole of the United Kingdom.

John Cridland: On the first question, it is not obvious to me that independence in itself would make a change to the cultural and entrepreneurial zeal of Scotland. I have many small companies in Scotland that are worldwide exemplars of entrepreneurial zeal, but the facts speak for themselves about the seedbed in Scotland. Whether Scotland remains in the United Kingdom or secedes, I think it is a major national objective for Scotland to strengthen its seedbed of small business growth. There are other parts of the United Kingdom where the same is true and you can see some consistency in the pattern, that if you have a bigger public sector dependency, you have a potentially weaker seedbed of small companies. You could say the same in Northern Ireland or the north-east of England; it is something that as a UK we need to tackle the further north and west we go. Your second question relates to probably the biggest area of imponderables. First, you would weigh up how to divvy up the national debt and then think about how you would look at oil and gas assets. Do you address that on a per capita basis, as I have suggested you would on the national debt? Clearly that would be very disadvantageous to Scotland. Do you look at it according to the laws of the sea? I am no expert on the laws of the sea, but there is considerable room for debate about where you draw national boundaries and where you extend them into the sea.

Lord Forsyth of Drumlean: Assume a generous settlement.

John Cridland: That could lead to a whole range of options. We have £8.8 billion of oil and gas revenues currently coming to the UK Exchequer that would need to be divvied up. How you divvy it up is one of the biggest questions of the economic impact of independence for
both parts of the United Kingdom. In many ways this debate draws us back to the economic impact on Scotland, but £8.8 billion of tax revenues is about 0.5% of GDP so it is equivalent on an annual basis to the austerity that the UK Government are bringing into the British economy. Those revenues matter hugely to the remainder of the United Kingdom as well as to Scotland. Looking at your terms of reference, on the wider economic impact, oil and gas assets play south of the border as well as north of the border.

Q302 Lord Forsyth of Drumlean: Let us assume a generous settlement: let us assume that Mr Salmond gets what he wants, 90% of the oil revenues. My question is: what do you think would be the economic impact on people running businesses in a country where such a sizeable proportion of the income was subject to the oil price, which is determined by all kinds of factors, as we know? How would that change the environment for building and creating business?

John Cridland: It would produce much more volatility. Volatility produces uncertainty and that is the most damaging characteristic for business investment.

Q303 The Chairman: Another point that a number of our witnesses have drawn to our attention is not only the volatility but the fact that such a large slice of revenue on a very small economic base has a much bigger impact than it would in the rest of the United Kingdom.

Graeme Leach: I was going to stress that point. The volatility in both the oil and gas price and the assumption about future output levels in those sectors feeds directly through to the public finances, which feeds directly through to the space you have left to reduce the size of the state in terms of expenditure and taxation. If you are hemmed in by those oil and gas output and price assumptions, you have far less scope to reduce the size of the state. That, in turn, has strong ramifications for the supply side, because that will ultimately determine the success or failure of any independence venture because it is shrinking the state, increasing the size of the market sector and getting higher productivity growth in that sector which is key. You could get stuck with the status quo in terms of the size of the state unless you have the scope that is given by the oil and gas sector.

The Chairman: We must move on. Lord Levene.

Q304 Lord Levene of Portsoken: A lot of large Scottish companies have been bought by companies outside Scotland; for example, Scottish Power and Scottish & Newcastle. Do you think that Scottish companies will invest and make takeovers in the rest of the UK more widely? How do you think investment flows could be affected if Scotland were to become independent?

Simon Walker: It really depends on the investment climate in an independent Scotland. If an independent Scotland cut corporate tax rates to the level seen in the Republic of Ireland, you might well expect to see more investment flowing to Scotland, possibly at the expense of the rest of the UK. It is not so much about independence as how an independent Scottish Government might behave and how the UK Government would respond. Of course, the other key factor is macroeconomic stability. We can see how the eurozone crisis has massively affected investment decisions and if an independent Scottish Government did have a poor credit rating, investment would be negatively affected.

Q305 Lord Levene of Portsoken: Coming back to the point that was made before, if an independent Scotland decided it wanted to stay in the pound sterling, would there be a
compact made beforehand as to the extent to which it had freedom to move outside the norms within the UK?

**Simon Walker:** I do not know how it would work. As Lord Lawson said, I suspect that the divorce decision will be taken or not taken on a political basis and matters like that, crucial though they are, will end up being worked out later on. I completely acknowledge that that is very uncomfortable for decision-making. But the argument is ultimately a political one.

**Q306 Lord Levene of Portsoken:** I would have thought that not knowing that there is a settled position would make businesses that are thinking of investing pretty nervous.

**Simon Walker:** There will be nervousness about that, certainly.

**The Chairman:** Mr Cridland, do you want to comment on that?

**John Cridland:** Uncertainty is the biggest killer for investment. At a time when there are many opportunities for those international balance sheets to be put to good effect in the new and emerging parts of the world, it is hugely important for the UK collectively—or, if it ever happened, independent parts of the UK separately—to make the best possible case for international investment. Of course, it is a two-way street. Some world-class Scottish companies have invested widely elsewhere in the United Kingdom and the world, but we should not be complacent on this question. International investment is hugely mobile and therefore we are putting out a shop window that needs to give the best possible impression.

**Q307 Lord Rowe-Beddoe:** To pick up on that last point, gentlemen, over many years Scotland has recently been number one of the regions or countries of the United Kingdom when it comes to foreign direct investment. What is the reason for that?

**John Cridland:** It has done a good job on promotion. It has had an approach to international marketing whereas in the UK we have had a somewhat fragmented approach. There is a Scottish brand that is rightly and proudly recognised around the world, which the wider business community within the different regions of the UK looks to with alacrity. It has set its stall out effectively over many years, and that goes back pre-devolution, to the days of the Scottish Office.

**Q308 Lord Rowe-Beddoe:** Is there any reason why this might change dramatically?

**Simon Walker:** There are many reasons to be nervous about that. I am not an advocate of a particular approach. The reasons that John Cridland has cited are absolutely accurate. It has been a good record and there would be concern about that being jeopardised by understandable worries globally about how the Scottish economy was going to turn out.

**Q309 Lord Rowe-Beddoe:** I well understand the differences between your memberships. I was closely associated with both your organisations. You are corporate, Mr Cridland, and you are individual, Mr Walker, and that is how individuals are going to vote. Corporations do not vote and that is how you get the differences in your soundings. Let us speculate. Let us say the decision is yes; we have an independent Scotland. What do you think the currency would be? What would Scotland prefer and what would the United Kingdom prefer?

**Graeme Leach:** The indications are that Scotland would opt for sterling but whether you opt for sterling or the euro you would face the issue that you do not control the currency in which you issue your debt.

**Q310 Lord Rowe-Beddoe:** What about your membership?
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Simon Walker: I have no doubt our members would prefer sterling.

John Cridland: Yes, absolutely, they would prefer sterling. But then you are back to the negotiation of the divorce. While the decision on Scottish independence is clearly a matter for the Scottish voter, the decision on whether sterling remains a currency available across the United Kingdom is a matter for the United Kingdom as a whole, not for one constituent part of it.

Lord Lawson of Blaby: That is not entirely true. Scotland can choose to use sterling if it wishes to, but the Bank of England would have no reason to take Scotland into account in deciding its monetary policy.

John Cridland: Exactly so.

Lord Rowe-Beddoe: Let us assume that Scotland has sterling, and becomes like Liberia or Ecuador, which use the dollar, what will that do for your corporations and your small businessmen? Are they going to like that?

John Cridland: If we were facing that reality, business would inevitably, pragmatically, accommodate the new circumstances and continue to serve its customers as best it could. Going back to my initial remarks, I am sure that the mandate I would be given would be to seek to retain the maximum amount of the single market possible. That is why all three of us agree that businesses, particularly small businesses, would much prefer not to have to worry about currency differentials and hedging and the costs involved in that if that eventuality was reached.

Simon Walker: I am sure that is right.

Lord Rowe-Beddoe: The Lord Chairman told you that a lot of the evidence we have received from academics indicated that the divorce happens and then the negotiation takes months—or even three or four years. How is business going to cope with three or four years of negotiation on such vital issues?

John Cridland: It does not fit business cycles at all, either for small businesses or the largest businesses making long-term investment decisions. Why do we have an economy at the moment where non-financial corporate balance sheets are very strong by historic standards but business investment is relatively weak? The answer is political uncertainty. In this case, it is primarily the political uncertainty of the eurozone, but it is a fact that the British economy is held back by political uncertainty. It is a killer for business investment and for business confidence. The questions that the CBI is raising about the possibilities of Scottish independence, while we will never receive full answers, are designed to try to limit the degree of uncertainty because uncertainty damages the British business community’s ability to maintain the living standards of our fellow citizens.

Lord Hollick: Is it not the case that Scottish businesses would quite like to have their own currency because that would then enable them to devalue when circumstances suggested that was the right thing to do? That would place them in the same position as some of the Nordic countries whose economies are of a similar size—sometimes larger, sometimes smaller—which have done rather well by having their own currency. I would have thought that there might be some attraction in having their own currency. I can see that, from a CBI point of view, it would be just another currency that large companies would have to manage, but for the smaller companies based in Scotland it could prove to be somewhat attractive.
Simon Walker: I have not heard that raised with any enthusiasm.

Q315 Lord Hollick: There is no “Bring back the groat” movement?

Simon Walker: Not that I am aware of. The uncertainty that we talked about is going to be there, and that will trouble everybody. On the other hand, I am sure that, whatever arrangement is eventually arrived at, business will adapt. But it will take time.

John Cridland: I need to preface my answer by saying that of course there are individual CBI members in Scotland who have taken the view that there would be economic benefits as well as political benefits from independence, but the position of CBI Scotland is to maintain the union. The position of CBI Scotland is no different from that of CBI UK—we are a single cohesive voice—and in that regard I have not had those representations.

Q316 Lord Hollick: Continuing down the speculative path, let us say that Scotland has voted for independence. The Scottish financial services industry is obviously an important part. As you properly pointed out earlier on, things have somewhat changed since 2007, so there might be some in Scotland who say, “If we had our own regulator here, we might not have been quite so reckless”. Who knows? It is easy to say that after the event. Would an independent Scotland have its own financial regulator, or do you see it being regulated out of London? When it comes to safeguarding depositors’ interests, how would you see that working? If you disaggregate the balance sheets of some of the large Scottish banks, the most toxic parts of those banks and the principal trading parts of those banks are not in Scotland but in London and other major financial centres. How do you, as it were, separate that out in order to ensure that Scotland has a workable and acceptable system of regulation and deposit insurance?

John Cridland: It is extremely difficult to separate out what are integrated businesses, where the biggest share of their business lies outside Scotland, whatever their historic routes or location decision. Therefore, in the scenario you have described, we would again be seeking to maintain the merits of the single market in financial services. In one small island with those integrated businesses, the logic would be that there is a single financial regulator—not two financial regulators. Just as I think there has been some shift in view in Scottish politics about the currency issue, I have seen some shift in view about the regulatory issues. After all, even outside the eurozone, we are increasingly moving towards more regulatory co-operation between existing nation states. I think that fragmentation of financial services regulation is damaging to business.

Q317 Lord Lipsey: I think we have done corporate taxation, so I wonder if I could ask about a quite different issue, which is immigration. We are now having a more and more restrictive immigration policy in England, whereas Scottish attitudes are clearly much more in favour of open immigration, which of course was for a good while—until recently—the policy of the Republic of Ireland. Would you like to reflect on some of the tensions that that might cause for your members, including the very real danger that Scottish companies would have access to skilled and competitive labour sources that might be closed off to England because of its different rules?

Simon Walker: I can certainly see significant problems there. One would imagine that an independent Scotland would have the same border-free relationship with the UK mainland as the Republic of Ireland has, and that would certainly be the preferred option. If an independent Scotland were to join the Schengen agreement, unless the UK also joined, one would expect the likelihood of border controls. I have been giving evidence to another Select Committee today about how important immigration is: our universities benefit hugely
from it and our members benefit enormously from skilled labour from outside the EU. This is a matter on which our members feel pretty strongly and have a pretty uniform view—something like 80% were calling for a liberalisation. Of course, as with the reduction in corporation tax, they would welcome a more liberal approach to immigration were that to be taken by the Scottish Government, but I can foresee all the problems if it ended up being used as a back-door route to England, which would seem to me likely. I can also see that Scotland has a steeper demographic challenge than England—especially the south-east of England—with a population that is ageing more quickly and a workforce that is shrinking. So I can see many problems and many difficulties.

John Cridland: I concur with Simon Walker’s assessment. I would only add that, in this list of things that need to be negotiated, the question of an independent Scotland’s relationship with the EU looms large. Is it negotiating with the European Union for entry? Is it a member of the European Union because it is a seceding part of the United Kingdom? The relevance of that comes back to the comment that Simon Walker made about the Schengen agreement. I think that business would want to know whether Scotland was likely to be bound to be a member of Schengen, because that would begin to weaken the open border that we would all wish to have continuing into the future between the rest of the United Kingdom and Scotland.

Q318 Lord Forsyth of Drumlean: Is the position not quite clear that Scotland would be applying for membership as a new member and would not be able to benefit from any of the opt-outs that have been negotiated by the British Government? You would get a differential situation, not least in the long term on the currency issue.

Simon Walker: Indeed.

John Cridland: I know that the SNP Government in Scotland seek to present a different view, but I have seen legal advice that would suggest precisely that.

Graeme Leach: Particularly with regard to financial services in any banking union.

Q319 Lord Lipsey: Throughout most of this session, we have been identifying problems for Scotland and England if Scotland breaks away. As Mr Walker says, this raises many problems, but they seem to me to be problems for England; for Scotland, they raise an enormous opportunity to have a more liberal immigration policy, which you say your members would welcome.

Simon Walker: Yes, indeed, and I think it would be of great benefit to the whole of the United Kingdom if it adopted a much more liberal immigration policy. I have no doubt about that, whatever the political arguments may be. It would certainly be of benefit to business.

Q320 Lord Tugendhat: I ask a similar question to those that I have asked before. To what extent is the immigrant community in Scotland much the same as that in the UK as a whole? Is it rather different? London is a very particular example—the situation in London is quite different from that in most other parts of the UK—but are the ethnic minority communities in Scotland on much the same pattern as those in the UK as a whole or are they at all different?

John Cridland: I do not have figures to justify this, so I can only give you a qualitative or instinctive answer. My experience in Scotland and in discussion with members of my Scottish council is that the ethnic richness of Scotland and the Scottish business community is an asset and I think very much reflects the wider UK. There is a very significant Asian business community in Scotland, just to give one illustration. I am not aware—although, forgive me, I
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do not have the figures in front of me—that there is a distinctively different pattern, if you exclude London, which I think we have to.

Q321 Lord Tugendhat: I have the impression, although it is merely based on being in Scotland from time to time, that relatively speaking in Scotland the Asian community is larger and the Afro-Caribbean community smaller and that one perhaps runs across fewer people—I may be wrong—from the former communist countries, certainly than one does in London. I do not know whether that differs between Scotland and the rest of the UK.

John Cridland: I am not aware that it does differ. I think that there is a significant diaspora from eastern Europe. One speaks anecdotally, but I have been in hotels in Oban where the staff have come from eastern Europe—and they have provided very good service. I am not aware that there is a distinctively different pattern but, forgive me, I do not have the statistics to justify that answer.

Graeme Leach: I live in Reading where there is a Polish version of the local newspaper. I was in Inverness last week and I was told that there is a Polish version of the local newspaper there as well, although I do not know whether that is conclusive evidence.

Q322 Lord Shipley: There have been a number of references this afternoon to the single market, the EU and the Nordic countries. Of course, an independent Scotland could join the EEA, to which a couple of Nordic countries belong. Has there been any discussion among your members as to whether an independent Scotland should join the EU or whether there might be scope within the EEA?

John Cridland: To the best of my knowledge, these issues have not been debated in CBI Scotland. I am not aware that that question has yet been raised.

Simon Walker: I am not aware of the answer to that either. From our perspective, too, the common market is a good thing, so if an independent Scotland were outside the EU but inside the EEA, we think that that would mitigate disruption.

Q323 Lord Lawson of Blaby: But in any event, you still have this uncertainty. Even if the Scottish National Party decided clearly that it was its policy to join the EEA rather than the EU, which of course is not the policy at the present time, it could not guarantee that, because it would have to be negotiated between a newly independent Scotland and the European Union. You still do not have any certainty; it is still all up in the clouds.

Simon Walker: That is true, certainly.

Q324 Lord Tugendhat: My last question almost brings me back to the first one that I asked, when I pointed out that, in previous meetings, we have been struck by the fact that people in the north of England do not seem to have thought very much about this issue. I wondered whether you felt that, in the event of Scotland becoming independent, your members in the north of England would look to strengthen the region’s local government. Might they, for instance, change their mind on elected mayors and issues of that sort?

John Cridland: The citizens of Newcastle have only recently pontificated on that issue. In the most recent election, if memory serves me right, they decided that they did not want an elected mayor. I am conscious, although we are now eight years away, that in 2004 the wider voter in the north-east of England rejected the then proposal for an elected regional assembly. It is certainly not my experience, working with the CBI in the north-east of England, that people are looking for greater governmental devolution. They want to be able to influence regional and local economic affairs effectively and they sometimes feel that there
is too much centralisation of economic power in the UK as a whole in contrast to some of our key competitor economies, but I do not think that the north-east business community, any more than the north-east voter, has shown an appetite for governmental devolution, as the votes in 2004 and 2012 illustrated. Whether that will change, as in your question, is hard to judge. I do not see any likelihood that it would change.

Simon Walker: I can see the possibility—but no more than that—of calls for some strengthening of local authorities. According to the OECD, this is one of the most fiscally centralised countries in the world, with, I think, just 4% of tax revenue set locally—essentially, council tax. I can see a debate about greater fiscal decentralisation and I think a debate of that nature would be a good thing to have, but it is a separate issue.

Graeme Leach: I have taken quite a few questions from members not about what the impact would be at the regional and local levels from a government perspective but about how it might transform politics centrally in England in terms ultimately of the composition of the House of Commons and what that means for the size of the state south of the border. I have taken more questions on that issue than on the local/regional issue.

Q325 Lord Forsyth of Drumlean: Just on that point, rather surprisingly, one or two prominent businessmen north of the border have said that they will support independence unless they get “devo-max”. Devo-max is not particularly well defined, but it appears to mean having control over everything except defence and foreign affairs. As Mr Leach has indicated, the implications of that are that we would end up with a federal constitution—because clearly with devo-max you would not have Scottish Members in the Westminster Parliament—and it would alter fundamentally the nature of our whole constitution. Do your members have a view on devo-max? Do they think this is a matter that should be settled by the whole of the United Kingdom rather than simply by Scotland, as in the case of independence? Are you concerned that some of your members are moving down a road that would mean very radical changes to the constitution of England? Listening to your evidence this afternoon, I get the impression that this is not top of their agenda or something that they think about, but the implications of devo-max could have quite a big impact on their businesses. How are your organisations tackling this question?

Simon Walker: I think most of our members have seen it as essentially a matter for the people and voters of Scotland.

Q326 Lord Forsyth of Drumlean: Including devo-max?

Simon Walker: The constitutional arrangements overall. They see the desire there. I agree with Graeme that the political implications for the United Kingdom as a whole are frequently noted by our members. They see what the political consequences would be for the House of Commons in that situation. I have certainly heard that noted and commented on. I have indeed heard criticism among our members of the shots in UK politics being called north of the border by previous Governments.

Lord Forsyth of Drumlean: Just to be clear, you are saying that if we were to move down the road of devo-max, you see that as something that would be a matter for the Scots alone?

Simon Walker: I have not heard our members saying that Scotland’s constitutional arrangements overall ought to be decided UK-wide. People south of the border are so uncertain about what devo-max might mean—
**Q327 Lord Forsyth of Drumlean:** I am not talking about independence, which clearly is a matter for Scotland; I am talking about devo-max.

**Simon Walker:** I stand by my answer. It is primarily seen as an issue for Scotland by our members across the UK as a whole.

**John Cridland:** Coming back to the referendum in 2014, the CBI's view is that the choice should be between maintaining the union and independence. That is the only clean decision and the only decision that can be had after a mature debate that addresses many of the questions we have raised in our evidence. I think that devo-max complicates that debate in a largely unhelpful way. I fully accept that devo-max raises a whole series of questions over the future governance of the United Kingdom that are not immediately raised by Scottish independence per se, but those are not issues that the CBI membership has yet addressed.

**Q328 Lord Hollick:** In your response to Lord Tugendhat’s question, Mr Walker, you showed a degree of welcome for greater fiscal decentralisation. Indeed, that is consistent with the stance that the IoD and the CBI take on greater competition in markets. Why would your members not welcome greater competition on taxation, particularly as earlier you cited Scotland introducing some taxes to help incentivise certain business activities? Would not a more competitive regime in taxes benefit corporates?

**Simon Walker:** Yes, I think our members would welcome tax competition per se. Certainly I have been cited examples by the IoD in Northern Ireland of businesses that are based south of the border that could and probably would have been based north of the border had it not been for the differential in corporation tax. Yes, I think they would welcome that competition. I do not think that is the only issue but it is something that they are aware of.

**John Cridland:** The CBI perspective is a little different, which may reflect the profile of our two organisations’ membership. Clearly there are upsides from tax competition and a significant section of my membership in Northern Ireland living with a land border with the Irish Republic is in favour of devolution of corporation tax to the Stormont Government. But the CBI UK’s position is that there is more to be lost than gained. We believe that the single tax rate and single tax base across the United Kingdom is a critical part of the single market that I have emphasised throughout my evidence, that the fragmentation of it would be damaging to business, that there would be significant operational costs in adhering to different tax systems, and that it would produce perversities of behaviour for non-commercial reasons in that people would move business assets around within the United Kingdom in order to attract lower rates of tax rather than for reasons of commercial necessity or opportunity. Therefore, the complexity of the tax rules would need to be increased because HMRC would need to protect the tax take by increased anti-avoidance. So you go down the slippery slope of judgments being made for non-commercial reasons and tax authorities responding with ever greater complexity. Overall, for businesses operating across the UK, that is damaging to the strength of the UK single market and we believe that overall there is more to be lost than gained.

**Q329 Lord Lawson of Blaby:** That may be a somewhat bureaucratic perspective, if I may say so.

**John Cridland:** Please.

**Q330 Lord Lawson of Blaby:** Just as price competition keeps prices down, generally tax competition tends to keep taxes down. Given the constant huge pressures for higher public spending in every country, if it were not for the benefits of tax competition you might get a
level of taxation generally that your members would understandably feel very uncomfortable with. Looking at the wider picture, might there not be a case for welcoming tax competition?

John Cridland: I am a strong advocate of tax competition between nations and I consider the United Kingdom a nation.

Lord Lawson of Blaby: Yes, but this inquiry is about when it ceases to be.

The Chairman: I think that is an appropriate point for us to conclude. You made it very clear at the beginning that, despite the many concerns and questions that you articulated, overwhelmingly the CBI was in favour of a single market, and you have just stressed that again. Of course, you also hope to see some of these uncertainties cleared up before the referendum takes place. I rather suspect that that is not going to happen and there will continue to be a great deal of uncertainty on a lot of these issues. In so far as our inquiry can help to disentangle some of these issues and get some answers, I hope it will be a contribution. Meanwhile, I thank all three of you very much indeed for coming this afternoon.
THURSDAY 25 OCTOBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witnesses

Iain McMillan, Director, CBI Scotland, Ian McKay, Scottish Chairman, Institute of Directors, and Liz Cameron, Chief Executive, Scottish Chambers of Commerce

Q641 The Chairman: I welcome everybody to the Economic Affairs Committee. This is the first time that we have been in Glasgow. It is the 13th evidence session of our inquiry into the economic implications for the United Kingdom of Scottish independence. I start by thanking Glasgow City Council for allowing us into this splendid meeting room, which is rather grander than most we are used to. In particular, I thank duty managers Gerry McSorley and David Pyper for arranging things for us. We will be taking evidence this afternoon from Gordon Matheson, the leader of Glasgow City Council.

Ms Cameron, Mr McMillan and Mr McKay, thank you very much for coming. You may be familiar with the work that we are doing, and may have followed some of our recent hearings. We were particularly keen to come to Glasgow and Edinburgh because it is very important, when we look at something like this, to give people here in Scotland the opportunity to give evidence to us. We have had quite a number of hearings already in London, so we have a fairly strong basis for our inquiry today. Would anyone like to give an opening statement or shall we go straight to questions?

Liz Cameron: Let us go straight to questions.
The Chairman: Good. Thank you very much. We are very grateful to CBI Scotland for the written evidence prepared in May for the Scottish Affairs Committee of the House of Commons. I have to say that I thought that the evidence asked a series of very penetrating questions about fiscal, currency, financial and regulatory arrangements in an independent Scotland. You raised a lot of questions that we had in our minds when we started this inquiry. We are still culling responses to those and I hope that we will get some answers to your own questions from you today. Do you feel that enough answers—or any answers—have emerged since May? Do you think that the Governments in Edinburgh and London are doing enough to make clear to voters in the Scottish referendum the economic implications of Scottish independence? The reason I ask that is that I share your view that it is not sensible to have a vote on this absolutely crucial issue without understanding the implications—particularly the economic implications, on which we are concentrating. Perhaps you could begin by saying whether you think that we are beginning to get responses to these questions, or whether there is still a long way to go.

Iain McMillan: Thank you, Lord Chairman, and thank you for inviting me, as the professional head of the CBI in Scotland, to assist the Committee with its inquiry. It is a very important piece of work. We are very supportive of the work that the Committee has under way and we wish to help in any way that we can.

With regard to the questions, I think that answers have been extremely slow to come forward. For example, on the question of the currency, we now know that it would be the intention of the Scottish Government to keep the pound sterling as the currency of an independent Scotland. But that gives rise to another series of questions which I do not think have been answered. For example, would the Scottish Government need the consent of the UK Government for that to happen? If that consent were given, how would Scotland’s inflation target be set? How would the inflation target be met if interest rates, which are inextricably tied to the currency of a nation, were under the control of a monetary policy committee somewhere else—presumably in London? So there are many questions around how a shared currency would operate. We have heard Scottish Ministers saying that Scotland would have a place on the Monetary Policy Committee of the Bank of England, but I do not know whether there is any evidence to support that assertion. The UK Government and Bank of England, as far as we know, have not responded positively to that statement. So we are left in the dark there. What conditions would be attached to the use of the pound sterling in an independent Scotland? There are a lot of answers with explanations outstanding.

Then there is the question of the European Union, which has been a matter of considerable controversy over the past few days. This was another question that CBI Scotland put to the Scottish Government. Would an independent Scotland have automatic rights to continue the UK’s membership of the European Union following secession? Opinion on this question seems to be sharply divided. Some leading academics say that, as the seceding state leaving the United Kingdom, Scotland would be leaving the European Union and would need to apply for membership as a new state that had come into being. Other senior academics disagree and say that as part of the United Kingdom, Scotland would automatically continue its membership of the European Union, with all the obligations and opt-outs that the UK currently has. We asked the Scottish Government whether they had gone to the European authorities to seek an authoritative view on the matter. The only answer that I have seen was a statement by the Finance Minister last November. He was quoted in the newspapers as saying that all his questions—and therefore mine—were answered two years ago in the White Paper Your Scotland, Your Voice. A spokesman for the Scottish Government, reported on the same day, 25 November, said the same to the Press and Journal and to the Times. So
there is a clear belief in the mind of the Scottish Minister that the question has been answered and that the answer is contained in the 2009 White Paper. But I do not see the answer there, and that may be something that the Committee will wish to explore.

There are other questions, for example about the full costs of statehood. An independent Scotland would need its own full panoply of government departments: a Treasury, a central bank—or perhaps not; we do not know—armed forces, foreign embassies and consulates, a revenue authority, a border agency and customs, various commissioners, regulators and so on. What would the cost of that be? Would we share some of these organs of government with the rest of the United Kingdom—or what was left of the rest of the United Kingdom? We need to know the answers to those questions as well, and we do not.

Then there is the financing of an independent Scottish state. We would very much like to see what the opening balance sheet, if I can call it that, would be, and what the budgeted income and costs would be. The only clue that we have is the government expenditure and revenue accounts, which are produced every year. They are of limited assistance because they are, of course, drawn up for Scotland as part of a larger state, and the cost profiles would all be different if Scotland were to be independent. These are the types of questions that we will be putting and we hope that between now and when the referendum takes place in 2014 we will have some very helpful answers from the Scottish Government to these questions and to others that will emerge as we go forward.

Ian McKay: The CBI has given a full answer. I will add my own appreciation for the Committee coming to Glasgow and Edinburgh. It is very helpful to see that level of commitment to this very important matter. It has been the IoD’s position from the outset that by far the most critical part of the debate is getting good data out into the public domain to allow people to take a reasoned decision when 2014 comes. In the absence of that, people are voting on their emotions or hearsay. In answer to your question, I think that the debate has begun to move on. We are starting to see some data emerging, and some more useful facts coming into the public domain. Unfortunately from one point of view, they are emerging from other sources. The Royal Society of Edinburgh and the British Academy produced a very useful document that started to set out some reasonable facts that either side could use, and indeed that the public could use in coming to a decision on the matter. It is good to see that. I said “unfortunately” because what is woefully lacking is anything coming from either side that offers us better facts—good, hard facts—on the situation. Certainly the IoD would encourage third parties, whether academics or perhaps some of our bigger companies and institutions, to get involved in this and to bring into the public domain data and material that would begin to offer some of those answers. I am sure that we will be saying something later in this session about how the data may be used by either side, but certainly the most important thing in our view is that this is a very similar situation to any business situation where a proposition is being put. The first thing that we would do is have a good look at the business plan and ask the proposer to show us due diligence. We still have not seen that diligence. As I said, I make that claim against both sides in the debate. Simply making assertions and rebuttals is not good enough; there has to be something to back them up. As Iain said, there really is not enough data out there.

Q642 The Chairman: We asked you to share your concerns. That is the whole purpose of our inquiry: to try to shed some light on the many detailed issues that we will be discussing. Given all the uncertainties and lack of detailed information, what impact is this having on Scottish business? Is it causing real concerns where particular aspects of the issues could fundamentally affect your businesses? Is it causing delay in investment and so on? I would be interested to know what effect this uncertainty is having. Allied to that, we get
some sense that a lot of Scottish businesses are unwilling to put their heads above the parapet, if I may put it that way, and spell out in detail the serious issues that might fundamentally affect them. It is quite difficult to tease out some of that at the present time. My final point, before we go into detail, is that the Director-General of the CBI told our Committee in London on 26 June that independence for Scotland would fragment the single market and that the CBI could not see the economic benefits in the case so far made. At that time the view was that it would be much better to retain the union. Does that continue to be your position?

Iain McMillan: Yes, it does. When the Director-General met you on 26 June, he made the position very clear. It is a long-standing position that we have held. We see the United Kingdom as a very large and single marketplace for business both here in Scotland and in other parts of the United Kingdom. We think that Scotland and its business community have benefited greatly from that seamless way in which businesses can conduct their business across the Anglo-Scottish border. As Mr Cridland said, that is our long-held position and we maintain that the case for independence should be made by those who wish to secede from the union. The onus is on them to do that and they have not done it to our satisfaction. We have seen no sophistication whatever in their arguments.

Q643 The Chairman: Ms Cameron, you did not indicate that you wanted to respond in the first instance. Would you like to comment now?

Liz Cameron: My apologies. I was waiting to be invited.

The Chairman: I am so sorry.

Liz Cameron: Thank you and good morning. First of all, thank you for inviting me as Chief Executive of the Scottish Chambers of Commerce to the debate this morning. Before responding to the secondary set of questions, I wanted to reinforce what my colleagues have said. I will not waste time by repeating it all, but I will say that we do not have all the answers to the questions we asked about independence—far from it. We have spent the past eight or nine months exploring the process, to the detriment of not getting into the detail of the environment that is going to be created, of what an independent Scotland could or would look like, and of what the implications would be for businesses operating in Scotland, and indeed the United Kingdom. Therefore, I reinforce that we absolutely do not have answers to a number of questions that my colleague from the CBI articulated so well. Moving on to whether the Scottish Government can answer all these questions, the answer again is no, because many of decisions are not within their power. What we are seeing is a wish list of what the SNP would like to see, but a lot of this will not be decided until after the referendum. Therefore, I think that it is important that, where possible in the run-up to 2014, we should be clearer in that respect. I would like to see the UK Government begin to set out some parameters, alongside Europe, to the answers with regard to currency and the banking situation. They could estimate what those parameters could be where we know some of the answers, because the business community needs that clarity in order for the electorate at the end of the day to make a decision driven by proper data rather than assertions and assumptions about what people would like to see. It is important that we are quite clear in that regard.

On your secondary set of questions on the effect of the uncertainty that this is creating, I will say first of all that we have 1,500 businesses across Scotland. Most of them are small businesses: 94% of our members have fewer than 50 employees, while the others are at the large, corporate end. Frankly, of course the referendum and these discussions are creating uncertainty; there is no doubt about that. By the nature of business, we are making decisions
and conducting long-term planning based on what the environment is going to look like in two, three, five or 10 years’ time. That in itself, like many other issues, creates uncertainty around our decision-making and our investment. Therefore, the quicker we get some answers to a number of questions, the quicker that will hopefully allay some of the uncertainty and bring some of the investment forward. At this stage, are we considering the referendum as something that is uppermost on our radar screens? The answer is no, we are actually busy running our businesses, and I stress that it is important that we get the balance right with the utilisation of government resources. The referendum will be one of the most critical decisions that the UK has made in a very long time, but we must get the balance right, because the economy is still in a very difficult position and we are still trying to run businesses. It is important that we get that message out to all political parties.

Ian McKay: I would like to add the point that it is also important that we ourselves are clear about what we are looking for. I would draw a distinction, for example, between the effect of uncertainty and an assessment of whether the end result of Scottish independence is a threat or an opportunity. Those are two different things which have a tendency to become conflated. Certainly it is the case that there is uncertainty out there, because there is a very major decision just around the corner. The IoD is an individual membership organisation. I imagine that I could look at my members across the whole of Scotland and find that every part of the opinion rainbow of the general public was reflected in our membership. It might tend towards one area or colour more than another, but in general all opinions will be there. It would be wrong, therefore, for the IoD to act in a way that could be regarded as partisan, or to take a particular stand in the debate. Of much more concern is to try to make sure that we are able to do due diligence and find out what the business case is on either side. When one begins to adopt that position, it is easier to start to put things in perspective. Anecdotally, I recall a discussion with some of the companies involved in a recent airport tender. I asked them informally whether independence was an important part of their thinking. Their response was that in their view this was a very important airport with a very bright business future in front of it and so on, under current circumstances. Should it then also become the airport that was serving the capital city of a country, they saw that there would be no difference. Their tender was being put together on the business case that they had for the airport. I was struck also by Paul Walsh from Diageo, who was asked a similar question on Radio 4 when he was announcing the £1,000 million investment that Diageo was making in the whisky industry. He quite properly said that they make their decisions based on where the whisky industry is going and on the prospects for the company. They recognise that although the referendum decision is incredibly important, one has to do what one does best and make decisions according to what is in the interests of one’s company, whether it is large or small.

One of the main points that I would be keen to inject into the debate but which tends to get lost is that whatever the shape of the country, and whatever form of governance one had, at the end of the day it is the policies of the Government of that country that will mostly affect whether business prospers and has a good future or whether it does not. We would be very keen to quiz both sides as to what their policies are towards business and how they see business going forward, given all the challenges that businesses have, both at this time and looking to the future. Whatever the form of governance, we need to make sure that the policies of whichever Government are helping business and helping the economy grow. We are much more concerned to have those kinds of answers from the protagonists in the debate than to put them down as a feature of any particular form of governance.
The Chairman: Thank you. I will take up one point that Ms Cameron raised. We asked Danny Alexander, the Chief Secretary to the Treasury, who was in front of us last week along with the Permanent Secretary to the Treasury, about all the work that they were doing on the detailed aspects of this issue that affect the Treasury and the economy. They said that they are now in the process of a substantial number of inquiries and will be producing a lot of papers. We have asked them for a list and a timetable of when we are likely to get them. Before we get into detail, there are two more questions on this general issue.

Q644 Lord Tugendhat: As we all know, the euro is an irreversible commitment on the part of the member states. However, we also know that, in the light of current events in the eurozone, lots of companies are making contingency plans in case the euro breaks up. Do you not feel that now there would be customers and clients in England and elsewhere in the United Kingdom who might be justified, in the light of the very considerable uncertainty that you have just explained to us, in making contingency plans in case there is a separation between Scotland and the rest of the UK? I think here particularly but not exclusively of financial services. It seems to me that individuals undertaking long-term financial commitments with Scottish financial institutions are faced with an element of uncertainty that does not apply to similar bodies based not only in London but in Canada or wherever else. I would be grateful if you could give me your views on that matter.

Iain McMillan: That, if I may say so, is a very good and relevant question. I think that the answer is that increasingly individual businesses are risk-assessing the independence issue. It is absolutely right that they should do so, and the CBI in Scotland and in the rest of the United Kingdom has been helping members in that regard. Individual sectors and businesses will quantify these risks in different ways. With any risk assessment, there is likelihood on one axis and impact on the other. Therefore, where the cross is made on the graph will differ according to the business and sector. A whisky company, for example—Ian mentioned one in his evidence—may remain in Scotland because that is where the product is made. However, one could well see companies in that industry risk-assessing the likelihood that a foreign country called England would set levels of duty on Scotch whisky higher than it might otherwise do if the country where the industry was based was part of its nation state. We know that the health lobby understandably makes all sorts of representations in that regard. These issues are very complex. You mentioned financial services. We know that by and large the financial services industry has more than 90% of its customers in the UK in England, but they are headquartered here. Again, I would expect that the companies in the sector will be risk-assessing this and possibly putting risk-mitigation measures in place.

Q645 Lord Levene of Portsoken: We have been working on this inquiry for several weeks now. What has been of concern to me since we started is that we have not really heard any strong arguments from Scottish representatives about why they think that this is a very good or a very bad idea. Clearly there are political and historical reasons that people can take a view from, but that is not what we are looking at this morning, when we have representatives from the business sector. This is clearly a momentous decision for Scotland and I would have thought that the business sector would have very strong views on it. They may think that it is great idea or a terrible idea, but nobody has said to us, “We think that this is a very good idea”, or, “We think that this is a very bad idea”. Some people have said, “Well, we don’t really want to stick our head above the parapet”. But if that continues, eventually a decision will be made one way or the other, and whatever the decision might
be, if it were a very bad decision for Scotland that would cause negative results and nobody had spoken up about it, they would have only themselves to blame.

I was surprised by Ms Cameron’s statement that, “We are waiting for the UK Government to give us some answers”. Yes, the UK Government do have to provide some answers, but because this is a policy and a wish of the Scottish Government, surely they should provide the answers to the people and businesses of Scotland. I know that if I was running a business and my main operation was in Scotland, and something as momentous as this was about to happen, I would have very strong views on it and I would want to make them known. The purpose of this inquiry is for our Committee to gather the facts in order to prepare a report on the likely economic effects—but nobody has talked about them. I just do not understand. You can understand individual companies saying, “We don’t want to come out in favour or against this because our customers may get upset about it”. But you three represent trade associations. Presumably you canvass your members and presumably from that you are able to assess their views. We would like to hear what Scottish business feels about this. We are totally unpartisan—we do not take any position on whether independence should happen. But if you do not tell us and other people very soon and then you do not like the result, you will have only yourselves to blame. This is not a new subject; it is not as if it cropped up last week. I wonder whether you three representatives can tell us what your memberships think about it. Even if they are saying, “The pros are these and the cons are that”, we are not hearing it. I would find it very helpful to have that sort of information to help us to produce what we need to say at the end of the day.

Iain McMillan: Thank you for that. I think that as an organisation, CBI Scotland has made its view pretty clear on this issue. As Mr Cridland said to you on 26 June, we are not claiming that our membership is unanimous. There may be some companies and members who either favour independence or who are completely unperturbed about the prospect. But the prevailing view, and a view that has been taken by the council of CBI Scotland, is that we are yet to be convinced that independence would result in a better economic and business environment. We have made that very clear and we have put questions into the public domain. I think that it is very unlikely that we would want to go further than that. In fact, I do not see how we could make it any clearer.

As far as individual business leaders are concerned, let me say something about that. In the main, business leaders today want to have good relations with the Governments of the jurisdictions in which they do business. They do not want to end up having a major row with the First Minister or Prime Minister, whoever that may be. Therefore, they are more content to leave the heavy lifting, if I can call it that, to bodies such as CBI Scotland that represent them. I am not suggesting that no business leaders will say something about this. Increasingly, as we move towards the autumn of 2014, some business leaders will express their views. I do not think that it will necessarily be a flood or that it will necessarily happen now, although some have spoken out.

There is another dimension to this. When I became Director of CBI Scotland in 1995, by and large the larger businesses in Scotland were run by Scots. That is no longer the case. There are still some, of course, but these businesses tend to be international now, and they are not being run by native Scots. Their view is that they will not get into a major row in Scotland over this. They will look at the prevailing conditions and they will adjust their business model to suit the constitutional and economic model in which they find themselves. That is increasingly the case.
Ian McKay: I think that we are making it perfectly clear that there is a need for business and other parts of civic society to participate in the debate. We are still two years off the democratic decision being taken. There is also, as I am sure we all recognise, a difference between the democratic issues involved in this and the economic, business or societal consequences of that democratic decision. Certainly we within the IoD are very keen in part to learn a bit from history. If I understand your point correctly, you are keen to see us climb aboard the boat and pin our colours to the mast. The big difficulty, as we said earlier, is that at the moment nobody has told us what sort of boat it is, where it is going, or the terms of the journey. I think that all of our members are very keen to get more facts out into the public domain in order more properly to assess that. Again, it might be helpful for us to consider that this is not the first time that Scotland has been in this position. If we go back to the late 1990s, there was a debate on the proposition to establish the Scottish Parliament. At that time both the IoD and the CBI were clear that this was a bad thing that was creating uncertainty, and that companies would up sticks and leave in droves and so on. A lot of things were said and felt at that time that never came to pass. I think that that underlines the point that I made earlier. At the end of the day, one judges Governments by what they do and the policy decisions that they take, rather than on any fears about what might happen.

I would say, Lord Chairman, in answer to your original point, that I do not think that any of us would want to give the impression, although we are very sensitive to our members and to their individual positions, that the business community is some kind of walkover and that we will not take part in the debate. We are very keen to be actively involved in the debate. It is correct to identify that there are certain sections within the business community for which we need answers much sooner than others. You are right to emphasise the financial sector. Some of the things that are being said around currency, a central bank and whether there would be a separate Scottish financial regulator and how that might develop are very pertinent and germane, particularly to the financial sector.

Q646 The Chairman: Let me stop you there because we will run out of time and I am anxious to get on to precisely these issues after we have been fairly general. Ms Cameron, would you like to comment on the general point?

Liz Cameron: On the general point, I support what my colleagues have said. But believe me, we will not stay on the sidelines. We will take part in the debate, certainly over the next 12 months. We are in a situation where we feel now that this is the cart before the horse in terms of what we are going to decide. We do not have the answers to a number of critical questions to inform the business community, whichever way they vote, about what that will mean to the cost base of doing business in Scotland, within the UK and internationally. That must be driven by clear data and a clear understanding of what it could mean if we were to vote for independence, and also what impact that would have on the rest of the UK. We have 26 chambers across Scotland and from January next year we have a series of detailed debates taking place, with detailed questions being formed as we speak that are coming from the business community. We will seek and demand answers. Our job is to get that information and intelligence out to the marketplace. That is what we are doing.

Lord Levene of Portsoken: Just two points. First, we were told that the business community needs to keep good relations with government. I have never known any business community that is afraid to stand up and criticise the Government; they do it all the time. Many of these businesses now are international and homed outside Scotland. It seems unrealistic to suggest that the owners will say, "It's nothing to do with us. We've made a £1
Confederation of British Industry (CBI Scotland), The Scottish Institute of Directors (IoD) and Scottish Chambers of Commerce—Oral evidence (QQ 641-658)

billion investment, but if they are going to change everything, it doesn’t matter, we’ll just walk away.”

Q647 Lord Forsyth of Drumlean: Could we move on to some specifics? Professor Bell of Stirling University gave evidence to the Committee. He said that the Scottish Government estimated that in 2009-10 the fiscal deficit in Scotland would have been 11% even with revenues from a geographic share of North Sea oil. Just looking into the future, do your members feel confident about being so dependent on a resource that is in long-term decline and whose value is driven so much by international markets and so is pretty volatile?

Iain McMillan: Yes, there is a concern about that. The number that Professor Bell gave you is interesting. There is no doubt that when one takes the yield from a geographic share of North Sea oil and gas into the accounts of Scotland—in a hypothetical sense because they are a UK resource—it takes the deficit down a great deal. In fact, in percentage terms of GDP, it takes the deficit below that of United Kingdom as a whole. But that makes the fiscal case for independence highly oil and gas revenue-dependent, which is a concern on three counts. First, the yield is volatile. Secondly, it is a declining resource. Oil and gas output peaked in 1999 at 4.5 million barrels of oil and gas equivalent a day. Last year it was down to 1.8 million barrels of oil and gas equivalent a day. There is a lot of life left in the North Sea; there was an announcement yesterday of a new licence being granted by the UK Government. But in the words of the Economist from 2005, we are into “the long goodbye”. Therefore it would be unwise for an independent Scotland to rely on oil and gas revenues on an ongoing basis to fund its public expenditure.

Liz Cameron: I agree with Iain’s statement. We have an issue because we are heavily reliant here in Scotland on the contribution that the public sector makes in expenditure terms. We are heavily reliant in the job market and the contribution of the public sector. That is another issue that needs to be considered. On oil and gas, we are going to make sure that we learn from the past four or five years, and the imbalance of the Scottish economy in certain sectors, particularly the financial services sector. Moving forward, whether there is independence or not, the challenge for Scotland and the rest of the UK is that we have got to get the balance right in terms of our economy. We cannot just depend on one sector. That is very important.

Q648 Lord Forsyth of Drumlean: What do you think will take the place of these oil revenues? Mr Harvie, speaking to us yesterday, suggested that it could all be done with windmills, tidal generation and so on.

Liz Cameron: The word here is “balance”.

Lord Forsyth of Drumlean: Balanced by?

Liz Cameron: Balance in terms of the sectors themselves. We are not seeing statistics that convincingly state that any deficits that could appear in our P&L could be covered by renewable energy. I think that that needs to be questioned.

Ian McKay: There is an irony here. Having made the point earlier that one of the big things that is lacking in the debate is factual data, the only area where we have had lots of data—and many different points of view on what the data mean—is in oil, and its importance and sustainability in an independent Scotland. We have had almost too much data, and what we are not getting is anything that would allow us to make a judgment on this. Perhaps I am saying this badly, but I share your concern that too much reliance is being placed on one particular factor in the debate. My colleagues were right to say that there are a whole bunch
of other sectors that are now starting to emerge, such as renewables and the whole energy area. Again, we need to start factoring that into the discussions. I am particularly concerned that there are too many assertions being made in the debate and too many false dawns being given about a number of quick-fix solutions—whether it is that lots of oil will enable us to pay for everything, or that we can do something with corporation tax so that all our fiscal problems will go away. That kind of answer to the debate does not in my view give any certainty to the business community or to the general public in making their decision. Where I would look for change is in the fact that Scotland continues to have a very poor record of business start-ups. Despite our history, our heritage and our excellent further and higher education sectors, we are not able to get the same level of business start-ups as there is in the rest of the UK. Whatever the government regime, we should do something about making that better. Similarly, I would be concerned that we grow the private sector in Scotland.

Q649 Lord Forsyth of Drumlean: Sorry to interrupt you, Mr McKay, but at the beginning you sensibly and rightly made the point that, if this was a business decision, you would do your due diligence and look at the facts. We heard evidence yesterday from the leading international expert based at Aberdeen University on the likely effects on oil reserves. Everybody is agreed that oil is a finite resource. We know that it is very volatile. We know that the oil revenues would be a substantial—relatively more so, of course—part of the revenues of an independent Scotland. We know that, if the revenues are very volatile, there will be years when there is not enough money to pay the bills, and so on. Surely it is possible for the IoD to take a view on this and reach a conclusion. We also know that if the Government suddenly find themselves short of cash because there has been a huge discovery of shale gas in North America or whatever, they will have to spend less. In a country where the private sector is so dependent on the public sector for resources, that will mean a loss of revenue and unemployment. If I say that, people will say, “Well, he would say that, wouldn’t he?” If Alex Salmond says, “That’s all nonsense”, I would say, “Well, he would say that, wouldn’t he?” The business community has a particular authority. On the one hand you said that there were not enough facts, but in this case we do have the facts. Should the business community not point this out?

Ian McKay: That is exactly what I was saying about the particular case of oil. When we consider what has emerged into the public domain in the public debate on the economics of independence, we see that oil has tended to be the only statistic that has been prominent. The difficulty that I was trying to illustrate was that the interpretations that have been made by both Governments and by a series of economists sometimes have not helped to give us clarity in the debate. I fully agree with you that, where we are able to identify data that give us clarity, it is extremely helpful both to business and to the general public. I would like to see more of that. But, as I say, it is not helpful when there is obfuscation and almost wilful misinterpretation of the data. That tends to make the general population say, “Oh well, they’re all twisting the facts”. That is the point I am trying to get over. I absolutely agree with you that we need to get better data into the public domain, not just on oil but on other related markets.

Q650 The Chairman: Have you made any assessment of the impact of the loss of funds from the Barnett formula, which will have a negative aspect on revenue raising and therefore on public expenditure in Scotland?
Ian McKay: My own view is that Barnett presents us with a different problem altogether. As you know, your colleague Lord Barnett himself has made it clear over the years that this was just a quick and dirty mechanism to agree a form of distribution.

The Chairman: For two specific years.

Ian McKay: Indeed—and he himself said some time ago that it should be done away with. However, it is the only thing we have, and it is the mechanism that has been operating.

The Chairman: It would clearly be part of any negotiation.

Ian McKay: Indeed it would—and it is correct to say that Parliament would obviously be affected by the changes that we are talking about. That said, Barnett is often affected in other ways as well. The way in which the UK Government allocate their money can also have a Barnett knock-on effect on who gets what cash. It is by no means a precise and well balanced system in the first place for us to use as a foundation.

I come back to my original point: it is the policies of the Government that will matter. For example, a year or so ago, when the Chancellor changed the tax regime for the oil industry more quickly than the industry was prepared for, that had a remarkable effect not just on one sector of the economy but on one geographical area of the country more than on many others. When people take decisions such as that—for example, on alcohol pricing in the case of the Scottish Government—they can have much more of an effect than a changed Barnett formula after independence. You are right to say that it is very important, but the difficulty is that there are so many interrelated and interchangeable factors that determine what comes out the other end that it is very difficult to say that one thing will make that much of a difference.

Lord Forsyth of Drumlean: I will make one point about Barnett challenges that might be helpful. When I was Secretary of State, my officials said, “Whatever you do in your negotiations with the Treasury, do not concede any move to a needs-based system of funding, as it will cost Scotland £2.5 billion”. I do not know what the data are now. Obviously, the figure would be considerably more.

The Chairman: We have looked at Barnett quite frequently in the House of Lords over many years. We must move on because we are running out of time.

Q651 Lord Levene of Portsoken: Let us jump forward a couple of years. All the arguments have taken place and the decision has been made in favour of independence. From the point of view of the business world, in that situation, which currency would you want to use? What would be best for business? Would you want to join the euro, stay in sterling or even issue a Scottish currency?

Iain McMillan: The answer to that question is that we would prefer to stay with the pound sterling. The reason for that is that, if Scotland adopted its own currency, it would introduce exchange-rate costs and risks in doing business with England—and with everyone else, of course. Were we to join the euro, the exchange-rate risks and costs would not exist in doing business with the eurozone, but they would exist in doing business with England. So that would not be a cause of action that we would support.

Q652 Lord Levene of Portsoken: Thank you. That is a very clear answer. I should know the answer to this, but I am afraid I do not. What percentage of Scotland’s trade is with the rest of the UK?
Iain McMillan: Scotland’s exports are worth £45 billion a year. About half of that goes to the rest of the United Kingdom—and about half of that is in financial services.

Liz Cameron: I have the figure for the EU. Seven out of Scotland’s 10 top international and exporting markets are in the EU.

Ian McKay: Perhaps I can add my tuppence-worth to that. I understand the question, but clearly the other part of that would very much be determined by the terms under which the separation was taking place. The easiest answer, which perhaps you would expect from us, is that business would favour the outcome that brought the least possible disruption and the least opportunity for damage to the business community and to the economy. Iain made the point very clearly that at the moment that would appear to be keeping the pound. However, it would hinge upon a third member of the marriage; the UK Government might have something to say on this after independence.

The Chairman: We will come to that. So your reaction is the same as Mr McMillan’s?

Ian McKay: It is.

The Chairman: Is that the same from Ms Cameron’s point of view?

Liz Cameron: At this point, yes. Based on the information that has been presented, I do not see any great advantage in not sticking with sterling.

Q653 Lord McFall of Alcluith: Before I come to my question, perhaps I might put a proposition to you. Melanie Reid in this morning’s Times said that the debate will take place on two levels: emotional and functional. She believes that it will boil down to a “stirring of the heart”. What we have felt on our journey to Edinburgh and to here is a frustration among people that this will not be an evidential debate. What can you do to assist all the political parties in promoting that evidential debate so that something is on the record? I wonder whether you could take that away with you, because the question is begging.

Liz Cameron: That is a good point. I am aware of time, but I think that all three organisations around the table have an absolute responsibility to ensure that we remove the emotion and stick absolutely to the economics of this decision-making. We have talked a lot this morning collectively about debate driven by data. Where the data are not given, our role is to ensure that we dig deep to get it, so that the electorate can make a decision based on economics.

Lord McFall of Alcluith: So is there a lot to be done in this area?

Liz Cameron: Absolutely.

Ian McKay: Just before you move on to that, I will say that none of us here would like to give the impression that this is not happening already; it is. All of our organisations are quite far down the road.

Lord McFall of Alcluith: So why are all the big questions begging?

Ian McKay: A lot of the big questions require big answers to come from elsewhere, and data to which we do not have access.

Lord McFall of Alcluith: That is the point that we are making. The politicians who appeared before us yesterday were frustrated in that. If the present torpor continues, we will find, as Melanie Reid said, that it will come down to a stirring of the heart and will not be
based on anything evidential. You need to give a push to that; will you take that message away?

**Ian McKay:** I think you will find that we are four square with you on that.

**Iain McMillan:** I am very happy to agree. As Mr McKay said, we have been doing that. The public reporting of this discussion will help with that process as well. However, there is a challenge here. What we are experiencing in Scotland is a party of devolved government that wishes ideologically to take Scotland out of United Kingdom. It is ideological and it is emotional. I understand why they do this; that is politics. They will make the emotional and the economic arguments fit the case as they see it. It is important that we get to the bottom of the economics of this. We have been doing that. My two colleagues and I gave evidence to the Scottish Affairs Committee in another place. My public statements on this regularly appear in the press. Our writings are in the public domain. I contribute to that, and that will continue.

**Q654 Lord McFall of Alcluith:** I do not want us to fall out over this. Perhaps I should compromise and say: “I agree that you have done it, but it has been so sotto voce”. So let us up the ante. My main question is about sterling. Further to Lord Levene’s question, if sterling were retained, should the Bank of England have a role as lender of last resort with Scottish-based institutions, or should an independent Scotland have its own monetary authority and central bank?

**Iain McMillan:** That is a very, very difficult question to answer, sitting here today. Mr McKay mentioned the negotiations that would need to take place. One thing we can be clear about is that if Scotland secedes from the union, the Government of what is left of the United Kingdom will look after the interests of that part of the UK—and rightly so. They will not look after Scotland’s interests. Therefore, that is where they will come from in any negotiation such as this. Clearly, from our point of view, we would like Scotland to participate as a member of the Monetary Policy Committee. However, it is very difficult to see how the Government of a foreign country—that is what England, Wales and Northern Ireland will become—will have any interest in being a lender of last resort to a bank based in Edinburgh.

**Q655 The Chairman:** I think that that is a terribly important response and would like to spend a little time exploring the issue.

**Iain McMillan:** There may be a collateral interest. If the failure to assist a Scottish bank would have a detrimental effect on the bank’s presence, depositors and borrowers south of the border, assistance might be given. The UK Government offered assistance to the Republic of Ireland. There was also the negotiation with Iceland over the impact that the failure of the Icelandic banks had in the UK. But it is very complex and if there was any assistance provided to Scottish banks, the invoice would follow.

**The Chairman:** We have had a lot of discussion on the question of what would happen if Scotland kept sterling and if the Bank of England was in some sense the lender of last resort. There would have to be very strict rules and a fiscal pact before there was agreement to that. The point that you have just made about the impact on the rest of the UK acknowledged that. What is your view on whether it would be desirable? A fiscal pact would probably include very strict rules covering when the Bank of England would intervene as lender of last resort in Scotland.

**Liz Cameron:** That is one of the key questions that follow Lord McFall’s point about getting the facts out to allow the electorate to make this major decision. As we said, a lot of
questions we are asking now will not effectively be answered possibly until after the referendum decision. It is fundamentally difficult for businesses and others to press the button for yes or no when they do not have key details. If there is a pact after a decision to separate Scotland from the rest of the UK, what would be the cost implications of that? What would happen to the cost of our borrowing? I put it back to Lord McFall and the rest of the Committee and ask you to report on some of these questions, decisions and answers that are outwith our control, so that we can be presented with some of the “what ifs”. Our three business organisations can then get them out to the marketplace to allow a decision to be made on the facts, because this is a critical question that will affect costs, jobs and the economy of Scotland.

The Chairman: I suggest that you read the transcript of our hearing last week with Danny Alexander, the Chief Secretary to the Treasury. He and the Permanent Secretary went into this issue, including the cost of borrowing that you just raised, in some detail. To some extent they answered the questions that you are asking.

Liz Cameron: Okay, thank you.

Ian McKay: It is important that, while we try to tease out the consequences of the decisions that people will have to take—the “if/then” scenarios—equally, we have to be very careful about trying to find solutions. I am particularly concerned that within this debate so far we are tending to have assertions made of what the case would be, rather than something that removes some uncertainty. For example, there is a current debate about whether with Scottish independence there would be a Scottish Government representative on the Bank of England’s Monetary Policy Committee. From what I can see, there is no basis of any kind in fact from anywhere to say whether there would be or whether there would not. Certainly there is nothing to say that we would have the right to do that just because of the situation. It would all be down to the negotiations between the Governments thereafter. I put it back to you equally that, were it the case—and we do not know the answer yet—that an independent Scotland’s membership of the European Union was conditional on joining the euro, a lot of the discussions that we are having now would be pointless. But that would be an equally important matter for people to take into account when they make a decision in this matter. There are an awful lot of incredibly big and important decisions there.

The Chairman: I will come on to the question of the EU in a moment, if we have time.

Q656  Lord Forsyth of Drumlean: I accept that no one knows what the position will be, and that a lot of assertions are being made. But all three of you are financially literate and understand how central banks operate. Surely the question that needs to be asked, if not answered, is whether you really believe that taxpayers in the rest of the UK would write a cheque if an independent Scotland got into difficulty. That is what we mean by lender of last resort. The taxpayer stands behind the Bank of England. Do you believe that that scenario is likely to arise? If it is not, what protection would an independent Scotland have if it was hit by a financial shock such as the collapse of the Royal Bank of Scotland, which would have been a catastrophe? You said that if you were in the euro, many of these issues would not arise because there would be the European Central Bank. But the people who are suggesting an independent Scotland are saying, as you endorsed, that we will not be in the euro but will have the pound as our currency. It needs to be made clear to people that these questions are real. The fact that the proponents of independence are not answering them surely does not take away the responsibility to highlight what could be a catastrophic position from the point of view of Scottish business.
Ian McKay: I think that we are making it very clear that we want to see a debate, but I am not prepared to answer a second question which is dependent on the answer to the first question. That is the difficulty. For example, in this case, you are going on to say what the relationship might be with the Bank of England as lender of last resort. My point is that if we have a vote for independence, and then a negotiation between the rest of the UK and the new Scottish Government about the terms under which Scotland can continue to be part of the sterling zone, it will be the terms of that agreement that will answer those questions and allow us to go on and find further answers to the other questions.

The Chairman: I think that Mr McMillan gave a very good answer to that question in this part of the discussion.

Q657 Lord Tugendhat: I have one question, as we are getting near the end. Would you expect an independent Scotland to introduce rates of corporation and personal tax that were lower or higher than those of its neighbour?

Iain McMillan: I think that that is impossible to say, as we do not know which political party would form the Government of an independent Scotland. Political parties have their own policies on matters of taxation. Let us assume for a moment that the incumbent Government would be the first Government of an independent Scotland. They have argued for corporation tax to be devolved within the United Kingdom as an interim step on the road to secession. They may be serious about that, but the impact on the public finances would need to be considered, as would the impact on other areas of taxation. For example, the Scottish Government currently refers to economic levers. If corporation tax is levered down, does that mean that income tax—or some other tax—will be levered up? Or will public spending be cut? Or both? We have a clue. We have a business rate—a local tax on property—which is applied uniformly across Scotland. The Scottish Government could have taken steps to cut that tax, as it does not have corporation tax in its quiver to fire from its bow. But they have not done that, so there is no evidence currently to support the assertion that corporation tax, or any other tax, would be cut.

Liz Cameron: “Expect” is an interesting word, because expectations and reality can be quite different things. We would seek to influence a favourable outcome for Scottish business: one that is globally competitive and affordable as well. We have heard assertions in some quarters that if people vote for independence, it will mean that corporation tax or personal tax will be reduced. It could go the opposite way, and we all need to be clear that that could happen. That is why we need the complete P&L, and why the appropriate answers must be presented by all political parties, before we can take a proper and effective view of what we are being told and what we could expect. Iain is correct about business rates. We deal with a lot of uncertainty in business, both from the Scottish and London Governments. We are hit with new taxes and sometimes increased taxes. In the business environment of the next five to 10 years, we must be clear that all this is affordable—which comes back to the point about our cost base.

Ian McKay: Let me add two very short points. It is becoming increasingly realised, elsewhere as well, that in a globalised world manipulating corporation tax in that way offers at best a very temporary advantage—and one that will probably come back and bite you, whether it is in Northern Ireland or here. The second point is that I take some comfort from the fact that, particularly in these more straitened times, the Scottish Government have had the ability since they were established to alter income tax by plus or minus 3p, but no Scottish Government of any political hue have used that power so far.
Q658 The Chairman: Your first point about corporation tax, Mr McKay, was very much backed up by the evidence that Alistair Darling gave us yesterday. The last question is very important. Does Scottish business see continued membership of the EU, including the single market, as economically essential for an independent Scotland?

Liz Cameron: Yes.

Iain McMillan: Yes.

Ian McKay: Yes.

The Chairman: You will know, not least from recent reports in the papers this morning, that a Spanish Minister has said that an independent Scotland would have to reapply for membership. The negotiations could be very protracted.

Liz Cameron: Yes, absolutely. I come back to the figures that we quoted. The EU is a very important trading partner for Scotland and indeed for all of the UK. We all need to be exceptionally sensitive to any changes that might affect our continued membership. We are advantaged by the opt-out clauses that the UK negotiated. The issue is not just about new membership; the cost implications of a new path could be potentially disadvantageous to business.

Iain McMillan: I support what Mrs Cameron said there. The Advocate-General of the United Kingdom has made public statements in support of the view that an independent Scotland would apply to join the European Union. I am not a lawyer, but one thing that I know is that, while the European treaties provide for member nation states to secede from the EU, they do not provide any clue to what happens if a subnational state secedes from a national state and puts itself outside the European Union. Taking that together with the statements of some senior European officials, an application to join seems to us to be the most likely course.

Ian McKay: Scotland has been an enthusiastic member of the European Community. We have long, historic links, even further afield than our neighbours in the south, to other parts of Europe. Non-membership would be unthinkable. The only thing that I would add is that that would affect much more than our economy and business. The effect on other parts of civic society, including treaties of law and education and so on, would create such a tsunami of uncertainty that it would have a very disruptive effect—which, as we said at the outset, would be very bad for business.

The Chairman: I am going to let a former European Commissioner put the last point.

Lord Tugendhat: I am going to recommend that you look at this morning’s *Herald*—which you have probably done anyway. The statement by the Spanish Foreign Minister is very interesting. You can talk to all the experts and officials and European institutions you want, but at the end of the day the people who will decide this will be the heads of government of the member states—and some heads of government may be a little more difficult than others.

The Chairman: Thank you very much. We definitely found agreement on the last question. The fact that our session has gone on so long and overrun is an indication of the importance of the impact on the Scottish business community of this issue. I expect that we will focus heavily on this aspect in our final report. Thank you very much for coming.
WEDNESDAY 24 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witness
Rt Hon Alistair Darling MP

Q564 The Chairman: Mr Darling, thank you very much indeed for coming. You will be familiar with all the issues that we propose to discuss with you. I think that you have seen the evidence that was given to this Committee last week by a successor of yours—and mine, as it happens—Danny Alexander. There were a number of issues there that we wish to explore with you. I was going to ask if you wanted to make an opening statement, but instead I will just give you the question that will enable you to do so. On what economic grounds—we are focusing purely on economics—do you oppose Scottish independence?

Alistair Darling MP: Lord MacGregor, I have read Danny Alexander’s evidence, as you would expect. Perhaps I should at the outset explain that, in addition to being the Member of Parliament for Edinburgh South West, I think that I am here principally because I am chair of the Better Together campaign, which was set up to persuade people in Scotland that we are better together and stronger as a United Kingdom. I am a director of that company, as my entry in the Register of Members’ Financial Interests discloses. I should probably draw that to the attention of the Committee.

Turning to economics, my position is not that Scotland could not go it alone. Most countries could go it alone. It would need some adjustment. As we have just been hearing, the Scottish economy would be very dependent on a very volatile revenue stream from North Sea oil. However, I am not arguing that we could not do it. My argument is the other way round. We are better off together because of the strength of the United Kingdom, its ability to share risks and the fact that it is by far the largest single market—as well as the importance
of the cultural and emotional ties, and the influence that the UK as a whole brings to the European Union, the United Nations, the IMF and so on. My argument is a positive one.

In relation to economics, my concern—and I think that this is a theme that the Committee has examined in its hearings—relates to key issues. For example, if we voted to become independent, where would that leave us vis-à-vis the European Union? You can see from this morning’s newspapers that in Scotland this is a very live issue. It would appear that the nationalists simply do not know the answer.

The question of currency is very important to us. Would we be part of sterling? If we joined the European Union, would we be required to join the euro? Equally, there are issues on which one cannot help but wonder, if one looks at all the problems and uncertainties, why on earth you would be doing this, because you are swapping a set of certainties—even though some are certainties you may not be very happy with and may want to change—for something around which there is a great deal of uncertainty.

This is not just my view. Professor John Kay told a conference here in Edinburgh in July that even if we voted for independence in two years’ time, it might take four or five years of negotiations, which in itself would be unsettling for a lot of Scottish businesses. So my argument is that we are better together and I think that there is something of an onus on those who advocate a separate and different course of action to say why—although I understand that you will be lucky to find somebody who will come and speak to you on that subject.

**Q565  Lord Levene of Portsoken:** Alistair, good morning. You mentioned currency just now. The SNP has said that an independent Scotland would continue to use sterling. What do you think would be the best currency option for an independent Scotland from a Scottish perspective?

**Alistair Darling MP:** My best option is as now. The pound is ours and the central bank is ours. You have three options if you choose independence. One is to have your own currency, but it would be a very brave country to set out on that course at the present time. The other is to use sterling, rather like Panama uses the dollar. That was the nationalists’ position between January and the end of February this year. Their position as I understand it at the moment is that an independent Scotland would seek to enter into a currency union with the rest of the UK.

There is one question that arises before all that. If you are going to share a currency with what would then be a foreign country, at some point surely you will need to ask that country whether it wants to enter into an agreement with you. As you know, the question of sharing our currency is of live political interest, usually vis-à-vis the euro. If you were going to enter into a currency union, first, it is inconceivable that either side would agree to it without having something written down. In other words, there would be rules, similar to the sort of thing that the eurozone is talking about at the moment. I say that because Alex Salmond said recently in Chicago—although I do not think that he shared this thought with us back here—that he did not think that there would have to be a written system of rules, which would give him room for manoeuvre. Knowing him, I can see why he might want that room for manoeuvre. However, on any view, and if you look at the eurozone model, which is the only working model we can look at the moment, things would have to be written down.
One thing that would flow from this is that, if you are in a currency union, both sides would have to agree to each other’s budgets. So we in Scotland would be in the absurd situation of having to submit our budget to another, bigger country for approval. As I said before, that is not freedom. That is not giving you more latitude than you have at the moment. If you look at the things that would also come with a single currency, you would have to have an agreement in relation to the central bank. In effect, you would have to have a banking union rather like the one they are developing in the eurozone. So what you are creating is a whole new paraphernalia that does not exist at the moment.

So my key objection to it is that at the moment we are part of the UK, but under the new system you would have to get someone in effect to approve your budget every year. If your whole argument—the nationalists’ argument—is that we are being held back, under this arrangement you would be shackling yourself to a system under which you could not move very far with someone else having to agree to it.

Q566 Lord Levene of Portsoken: You explained exactly the perspective from the Scots’ point of view. But if you were looking at this from the other side of the table, would the rest of the UK be better off if Scotland did not maintain sterling?

Alistair Darling MP: You are asking a question that has never been put to the rest of the UK. If Scotland voted to become independent, there would be problems if another country started to use your currency but you had no control whatever over what it was up to. At the moment the two economies are fairly close together, but if Scotland were to go on a radically different path—if its borrowing were to increase—it would bother the rest of the UK, which issues the currency, that another country was doing something that it found difficult. You cannot stop someone using your currency, as we know. I do not think that the eurozone is very happy that Montenegro uses the euro, but, frankly, does it matter with Montenegro? Scotland is rather more sophisticated, so I think that it would matter.

I think that if this were to come to pass—and this is the publicly stated position of the nationalists at the moment, and has been since March of this year, so we will take it at face value—they would favour some sort of framework. I would have thought that in the circumstances, having rules to govern these things is far better than leaving things to chance.

Lord Levene of Portsoken: It takes two to tango. The other party could say, “We do not really want you to do this, so you have to go and do your own thing”.

Alistair Darling MP: I do not think that you could stop another country using your currency. Frankly, it would be in the interests of both countries to have some rules and regulations. What I do not think they would agree to is a formal currency union without anything being written down, when there would be no checks and controls. Indeed, if you look at what is happening in the eurozone, that is how they started off. Then they had the stability and growth pact, and it was actually France and Germany that drove a coach and horses through that, which demonstrates a rather different point about who calls the shots in Europe. They are now moving to a very rigid system of budgetary approval, controls and so on. That is the model that is around and that is where you would end up. That is why I cannot for the life of me see why, if your whole thesis is that the rest of the UK is holding us back, you would enter a formal legal mechanism that locks you into a policy that another country has to agree to.

Lord Levene of Portsoken: You said at the outset that you did not really see why anybody would want to do this in the first place.
Alistair Darling MP: I do not see it. The argument they are running at the moment is that everything will change, but nothing will change. Whenever you raise any questions, the response is, “Don’t worry, that will all get sorted”. Your question would be better put to a nationalist—if you can find one.

Q567 Lord Tugendhat: Can I put a question to you that I put earlier this morning about the direction of travel? The markets gave the eurozone a good deal of slack in the early stages because they believed that this was an irreversible arrangement leading to a closer political union. People made all kinds of judgments based on that—and it has now been called into question. In the case of Scotland and the rest of the UK, this fiscal pact, currency union or whatever would be formed after a separation, so the direction of travel would be in the opposite direction. It would be an agreement between two countries that had just separated rather than a group of countries that were coming together. Therefore, there would be great difficulty from the outset in gaining credibility of the markets for the durability of this arrangement. It would be seen not as a step towards closer union, which the eurozone was, but as a way station towards some further element of separation.

Alistair Darling MP: Apart from death and taxes, as has often been said, nothing is certain. Trying to predict what will happen at the moment is very difficult. Your starting point is right, of course. The whole concept of the common currency was ever increasing economic and then political union. That is certainly where the single currency takes you, whereas this has been constructed to achieve precisely the opposite. I would argue that you may start off that way, but sooner or later, with the pact that you would have to enter into, you will have increasing economic and political co-operation, which ultimately will take you to economic and political union. Again, the question is, “Why have you gone through all this trauma precisely to end up where you started?”

There is an added complication. I mentioned the policy changes in relation to currency. We do not know the answer to this, but if Scotland had to reapply to get into the Europe Union and if one of the conditions was that you had to sign up to the eurozone, you would have the odd situation that you had signed up for a sterling currency union but at the same time within whatever timescale, you were also bound to enter the euro. That is why the whole question of where Scotland stands vis-à-vis the euro is critically important, because I suspect that that would have a great deal of bearing about what you did about the rest of the currency. There is an example here of two massive unknowns being imposed at a time of huge economic uncertainty.

The last point that I would make is that you are right that, when the euro was launched in 1999, all the problems that we see today were known about and were talked about. If you look at the then British Government’s critique on the euro, published in 2003, you will see that the Treasury identified all the problems that have now come up. On any view, if Scotland voted to become independent in 2014, the current economic turbulence is not going to be resolved. My guess is that the legacy of what has happened over the past four years will be in people’s minds and in the markets’ minds for the next 20 or 30 years. You are not launching this ship in calm, untroubled waters. You are launching this ship in deeply turbulent conditions. I do not have an answer to this because I am not advocating it, but I am saying, as a practical person with some experience in what happens when you try to fix things in the middle of the storm, it is not a happy place to be doing it, especially when you do not actually seem to know what you are doing.

Q568 Lord McFall of Alcluith: You mentioned the Alex Salmond’s Chicago speech and room for manoeuvre. Jeremy Peat from the David Hume Institute said that there could be
quite a high degree of room for manoeuvre with different corporation tax rates under a fiscal pact. Could you give us your view on that? Do think that there will be?

*Alistair Darling MP*: The point of having a pact is that you would have to have various levels of agreement. A simple one would be that you had to look at each other’s budgets. The next step is that you would have to agree to them. You might—as you are seeing within the eurozone just now, where they are starting to try to bring together tax rates, which is controversial, but that is the way they are going—say that you are not going to agree to something if you deviate too far in relation to one tax or another. It all depends on what is in this agreement. Part of the problem is that we will be voting in this referendum in advance, possibly, of knowing what these agreements will be, because they will only come along after the event.

It is increasingly obvious that no thinking has gone into any of these things until comparatively recently. The nationalist Government were completely taken aback when they knew they were going to be confronted by a referendum. Like many of us, they thought that it would never happen. On an issue like this, we will not know when we go to the polls, presumably, in the autumn of 2014, what the fiscal pact will actually look like or what any agreement might be. The answer to your question and the point that Jeremy Peat was making is that there are a lot of unknowns, and we will not know them until after the event, which is a pity.

**Q569 The Chairman:** But would you not agree that it is important to classify and list what the unknowns are?

*Alistair Darling MP*: Yes. It is like anything else in life. You are taking a decision that will affect the rest of your life and this one is irrevocable—we are talking about the next maybe 300 years. Some things you do know about or you can get the best possible advice on—for example, our position vis-à-vis Europe. I hope now that we will get some clarity in relation to that. But this is something that has to be negotiated.

I am not here to speculate about what is going to happen in the general election in 2015; we do not know what Government will be around at that time or the complexion of that Government. It will almost certainly be different from the one that is around at the moment. We will not know those things any more than after 2016 we will know what the Scottish Government look like. All you can do is to say, “Look, if you narrow down these things, what is more likely than not?” I keep coming back to this point. There is no way that there will be no strings attached. Think about it: why on earth would the other side, assuming they are willing to agree to this, basically write a blank cheque? We would not do it for them and they would not do it for us.

**Q570 Lord Hollick**: I am afraid that I am going to continue the journey into the unknown. Two things: as you said, there is a live issue around the application that Scotland would have to make to join the European Union. What in your view are the key economic issues that would arise out of that process? Secondly—you have already referenced this—Scotland has a very important financial sector. Two of its largest banks were casualties, as you know from personal experience, of the great crisis. How would you see regulation going forward in an independent Scotland and who would be the lender of last resort? Who would pick up the tab to ensure that Scotland’s financial community and its major financial institutions did not simply fall over?

*Alistair Darling MP*: Let me answer the second question first, if I may. Scotland would need to have some sort of arrangement, either having its own central bank or presumably
borrowing the one that was in the rest of the UK. The thing about the Bank of England is that people think that it has unlimited supplies; if the Government need money it says, “There you are. We can help you out”. It is not quite like that. The Bank of England is largely funded by the UK Treasury. Its balance sheet has gone from about £100 billion four years ago to £400 billion now. How is it able to do that? Basically because the UK Government stand behind it and for as long as the world believes that the UK Government is credible, that is fine and you can do that. That was important.

I can give you an example. If you look at the total support given to RBS—the decisions taken that brought that bank to its knees were taken in Edinburgh, not anywhere else—the total cost to the UK Government was about 21% of GDP. The comparable figure for Scotland was 211%. That gives you some idea of how important it is to have a central bank that is bigger. The night that I had to bail out RBS, I was conscious of the fact that its balance sheet was just about the same size as the UK balance sheet for GDP at that time. I could do it, and I did it sufficiently quickly, before people had a chance to think about it, and it worked. The Irish Central Bank tried to do the same to guarantee its banks and people said, “Hold on. You are a fraction of their size. We do not believe you”, and look what happened. A similar sort of thing happened in Iceland. You need a central bank. If there were to be some sort of arrangement with the Bank of England, we would presumably say, “Okay, we’re guaranteeing the Scottish banks, so someone needs to guarantee that payment to us”, in the same way that currently the UK Government guarantee the Bank of England. They would either have to rely on a guarantee from the Scottish Government, in which case the question arises, “Have you got the money if we call this guarantee?” or we would have to require some additional funding or insurance that would impact on the ability of RBS, that part of Lloyds still operating here and so forth to do that.

Those are the issues as I see them. This complicates the whole thing and this is why this is not just an academic debate: it is very real to us. First, in relation to the banks there is the whole question of the banking union and how that will impact on Scotland. If you step back from that, the prior question is whether we would be in the EU in the first place. I take it as a given that it is in Scotland’s best interests to be part of the European Union. I do not know of any mainstream opinion that would argue that we should come out. The first question I ask myself is, “Would there be any doubt as to whether we would remain in or whether we would have to apply?” Mr Barroso says that we would have to apply and Alex Salmond says that he does not know what he is talking about. It now turns out that Alex Salmond does not have the legal advice that he led us to believe that he had on that point. I do not know. If we had to reapply or even if we stayed in, do we keep the opt-outs that Britain has or will we have to apply for those? Where would be on the whole question of joining the euro, the Schengen agreement, fishing quotas? All these questions would be up for grabs.

I know enough about the European Union to know that there are two things that govern what happens. One is what the law says, but equally important is the politics. Europe is run by large countries. Some of them, especially Spain, will take quite an interest in what was happening if a country decided to break away from the UK but wanted to continue in the EU. Spain would have in mind that it has on its doorstep with the Catalans, the Basques and so on a similar issue, and they are not the only ones.

I keep saying that this is an area where there is significant doubt. It is not helped by the fact that we were led to believe that there was legal advice and it now turns out that there was nothing of the sort. It is such a critical issue and it really is critical to Scotland’s future. I do not doubt for one moment that the First Minister will be able to find a lawyer to back up what he says, because lawyers can always do that if they need to, but what worries me is
that there is so much doubt about this. This would not just influence our economic well-being. Critically, if you look at what is going on in the banking union that is now being set up in the eurozone, if I was running RBS or Standard Life or any these companies I would want to know who would be regulating me. How many people will be regulating me? If I do not know that, my investors start to worry. Remember you are not just talking about investors in England; you are talking about Americans, who sometimes have a knowledge of what is going on in parts of the UK that is not quite as thorough as we might like. The perception that something has changed and the perception that there may be uncertainty and doubt about who is running things can be extremely damaging. Again, why are we doing it? It is an industry that 10% of our GDP depends on.

Q571 Lord Hollick: Have you detected that those concerns that you have expressed are shared by the financial institutions and potential investors in Scotland?

Alistair Darling MP: Very much so, although they are reluctant to speak up about it, because they need to work with the current Administration. But of course they are concerned about it. Take the insurance industry in Scotland. Something like 94% of its products are sold south of the border, while 6% are sold here. If you own a company like that, you are bound to say, “What is this doing to the risks that I have, the systems that I have to operate, my cost base, and so on?” So of course they are worried about it. Equally, there are people who manage American money here—and Edinburgh is a very important financial centre in European terms. The first question that the Americans ask is, “Who regulates you?”

There is a final point here on another complication. If we become a member of the European Union, the law is that we have to have our own regulatory regime here. We could not borrow the FSA or the Bank of England at some point next year. The law says that you have to have your own compliant regulator, so that would be another thing that we would have to set up. Most of my constituents in the private sector work for these financial institutions and they are worried about it.

Q572 The Chairman: Everything that you say in response to that question adds up to huge temptations, pressures or however else you would like to describe it, for these financial institutions and the banks to headquarter elsewhere, where they have a regulatory system and a central bank that is well understood and accepted by investors.

Alistair Darling MP: Speaking to them, I think that they would be extremely reluctant to do that, because most of them have chosen to be here and grown up here. They like living here and they like being here, where there is a very skilled pool of expertise. One has to be wary about shroud waving on this. My biggest concern is that the more you have uncertainty, the more doubts that you raise in people’s minds, in the international financial services industry that is terribly unhelpful. It really is. Frankly, it is not going to be good enough for Scotland to hold on to what it has got; you are not going to survive that way. We need to get more people to come here; we have lost quite a bit after the survey in relation to HBOS. It is from that point of view that I worry that, in relation to people who are footloose and can go wherever they want, if we say to them, “Come here, but we can’t tell you what is going on for a number of years”’, it does not help.

Q573 Lord Forsyth of Drumlean: Alistair, just following up on that point, and not wanting to indulge in shroud waving, you made the point earlier about the relative size of the banking sector in the Scottish economy, as opposed to the UK economy. One thing that struck me—I am in the middle of reading your book—was the extent to which the
credibility of the UK was absolutely central in being able to mount the rescue plan that was carried out. If those financial institutions such as the RBS were to find themselves in an independent Scotland, given the size of the national balance sheet that would then exist, would that not have a knock-on effect on its ability to raise capital, and the cost to it of raising capital, relative to being located in the rest of the UK? However much it wanted to remain in Scotland, with all the advantages that Scotland has, would the economic pressures move it towards relocating south of the border, which was the Chairman’s point?

Alistair Darling MP: First, thank you for reading my book. Secondly, Philip Hampton, who is the Chairman of RBS, said in the last few months that it is not an accident that large financial institutions tend to be based in large countries. When people look at a financial institution, they are going to ask where it is based and who stands behind it. If you look at Iceland, for example, an Icelandic bank would have a hell of a job pitching for business. That will be in people’s minds. I passionately hope that we can do everything necessary to keep these financial institutions based in Scotland and to attract more, as our prosperity depends on it—it is too big to let go.

It is pointless to speculate what will happen, and I think that RBS would dearly like to stay here, for a whole range of reasons. But it is rather like the argument that we have perennially about London vis-à-vis New York or Hong Kong. From time to time, Governments have done things that have moved the centre of gravity—the obvious one is between London and New York, when the US Government introduced the Enron legislation. That gave London an advantage. From time to time, we have done stuff here that has pushed it the other way. That is just life—that is what people do. I am not in a position here to tell you that if you want particular things there are going to be certain consequences. This is a debate that we have had for two years, but the thinking on it is at a really elementary level. It is patently obvious that virtually no thinking has gone into how this would actually work, when this would disengage us from something that has been built up over many years and is complex, and has been built up for different reasons and at different times. You are talking about bringing it to an end in fairly short order in a very uncertain world.

Q574 Lord Forsyth of Drumlean: Let me pick you up on something that you said earlier. You were asked about what the financial institutions were saying. I think that we both have a similar experience that they will say things privately; they do not wish to get involved in what is seen to be a political debate or say things that may damage their relationship with the Scottish Government. In the last 24 hours, we have learnt that it is quite difficult to get information that is trustworthy about central tenets of the debate. You mentioned the particular example of our relationship with the European Union. You, obviously, are wearing a partisan hat, because you are arguing against the break-up of the United Kingdom. Have you any thoughts about how it would be possible to get information that relates to the economic consequences of independence that is trustworthy and is not going to be seen as coming from a partisan source? In my days in the Scottish Office, there was a strong Civil Service, and there was a strong set of rules to separate a government announcement from one of my political press releases. It seems to me that these boundaries are being blurred. Do you have any thoughts on how we can get into the debate informed, objective and trustworthy advice on these big questions such as the lender of last resort, currency and so on?

Alistair Darling MP: Yes, I do. I know that it is something that you explored when Danny Alexander gave evidence to you last week. This is something that would be tremendously helpful. We have two years of debate at time when public esteem of all political parties is
pretty low. We know from our own polling that when it comes to the question, “Who do you trust to tell you the truth?” politicians are right down there. There is a thirst to know some of these things; there are a lot of things that are just unknown and we will not know until we get there. The UK Government are planning, as I understand it, to publish position papers on a range of matters—10 or 15 different matters that they think are central to this. One thing that I hope they will do is to get them externally validated, or at least commented on. One thing that we did with the European assessment in the eurozone 10 years ago was to prepare a paper in the Treasury but then to get professors or other experts from outside government to pass judgment. They did not say, “Yes, that’s 10 out of 10—that’s right”, or anything like that. They said, “Yes, these assumptions are reasonable”, or, “We beg to differ on this”. In other words, you have a UK Government publication, but someone from outside has looked at it and said that it is right or that they are not too sure about certain points.

I understand that the Scottish Government are going to publish a paper in about 12 months’ time, which they will prepare. Especially following yesterday, I think that there will be a big credibility problem now. People will just not believe it. So for their own good, what I would do if I were them is to get it published and then get other people to look at it and say, “Yes, this is a stateable case”. If we do not have that, the risk is that one side will say one thing and the other side will say another and the public will think that these are just politicians scrabbling around, and the whole process will not fit the debate that we need in Scotland over such a crucial issue.

The last point is that, in relation to Scottish firms, I hope that people who have a view about what happens to the country, whether in business or individuals, speak up. There is no point in keeping quiet and then saying, “I wish I’d said something”. That will not do. Firms have said to me, “Look, we do not want to fall out with the Government”—although as I know to my cost it did not seem to stop them when I was in the Government. You have to remember that politicians need businesses here more than businesses need politicians, so they do not have anything to be afraid of. They need to speak up, because the public will listen to a big financial firm or someone who trades. They will listen to people who have no obvious axe to grind. You have just heard from Professor Kemp, who is a world-renowned authority on the North Sea. People will listen to him—and sometimes he will say things that suit your argument, and sometimes ones that do not. But that is how it should be. We need that discourse if this is going to be a debate where people can make up their mind on a reasonable basis—and I use that word advisedly—before they go to the polls.

Q575 Lord Forsyth of Drumlean: Another thing that you said, and which we have discussed this morning already, is that you need a set of rules if the Scottish Government are to use sterling in an independent country. I am not clear how you can enforce those rules. Would Westminster fine Scotland? What would be the stick with which those rules would be enforced? That is how the Maastricht criteria went wrong in the first place.

Alistair Darling MP: That is an interesting point. If you take the eurozone point, there is a Commission that sits on top which can enforce matters. There is no such structure here. Leaving economics to judges seems to me to be full of difficulties.

The Chairman: Would you like to go on to the subject of the division of assets?

Q576 Lord Forsyth of Drumlean: Yes. If you were back in 11 Downing Street, faced with the Scottish people having voted to break up the United Kingdom, how would you go about the division of the assets? Obviously oil is one, but debt is another. How would you approach that?
The Chairman: And liabilities.

Alistair Darling MP: My guess is that it would be quite a long process. Some of it is fairly straightforward. Some of it is just a case of changing from one country to another. However, there are complications such as the Royal Bank of Scotland, which I suspect, 10 years ago, people would have killed to get that in Scotland, but I am not so sure now. It is physically here as a registered bank, but NatWest, for example, has by far the largest part of the retail side south of the border. That has implications for the deposit protection schemes and so on. There would have to be discussions about that. In relation to oil, there are probably enough pieces of treaty evidence and international agreements at the margins of the arguments. Certainly it is less complicated than you might think. As you have just been hearing, the whole question of decommissioning is far from straightforward. The rest of the UK might say, “Okay, we accept that geographically North Sea oil is in Scotland. No one told us that the government revenues were also going to pay for decommissioning costs”. So it is bound to be more complicated.

Other areas, too, do not have the attention that they deserve. The area of pensions is one. Public sector pensions, as we all know, are pay as you go. What do you do if a civil servant has worked most of his life in London and retires to Edinburgh? Who pays his pension? How do you divide these things up, because there is not a fund you can divide up or anything like that? Equally, if you look at some of the shared functions, like HMRC and DWP, what do you do about the fact that a lot of HMRC and DWP employees work in Scotland but are largely doing work for people in the rest of the UK? What do you do about all that? Then there are the defence assets and so on. How do you divide them up?

I am not arguing that it is impossible—it is possible—but again we come to an interesting point that everyone will want the best deal for themselves. You sometimes hear the nationalists saying, “Well, don’t worry, on RBS, we will only take on the liabilities close to independence”, despite the fact that this entire calamity was engineered in Edinburgh, in Scotland. The idea that it is all the fault of the regulator is a bit like a bank robber arguing that the police should have stopped him. It is just nonsense.

It can be done but I am just wondering who will arbitrate at the end of the day if it does not work. Will we get an impartial referee who will judge this? Of course it can be done, but it is complex. Again, I hope that, over the next two years, we can have a little light on what the issues are. On some things we may say, “We don’t know, but let’s find out”. If I were in receipt of a public sector pension, which I might be in a few years’ time, I would like to know what the arrangements are.

Q577 Lord Tugendhat: There is another parallel with Europe, I think. If you look at the argument over banking union and the Spanish and Irish, and so on, should the new arrangements take account of the legacy debts? Mrs Merkel is saying that she only wants to take on the debts post the new arrangements. It is not a dissimilar arrangement. I want to ask you a question about tax. Do you expect that an independent Scotland will seek to introduce different rates of corporation and personal tax and, if so, to what extent do you think it has freedom of action, both in relation to the rest of the UK and within the confines imposed in the European Union?

Alistair Darling MP: Just on the question of debt, that is another issue where I suspect there will be quite a lot of fraught negotiations. It is important that Scotland will be moving into a debt market, where it would have a sales debt as a new entrant—the amount of debt that it had to service would be a critical issue. That is important. In relation to tax rates, let us take the corporation tax rate. When you listen to the arguments advanced by the SNP,
one thing that they keep coming back to is that they want to reduce corporation tax. Therefore, I assume that it would change. That assumes that the European Union will let this practice go on much longer—as you know, it was deeply unhappy about what was going on in Ireland. As regards Ireland, you do not kick a man when he is down, but I can come back to that. Suppose Scotland cuts its corporation tax and it worked. How long do you think it would be before the rest of the UK thought, “Well, it’s working; who will cut our rate too?” Obviously, in the light of our economy, the less dependent on one particular tax stream you are, the easier it is to cut it. Then you get the ridiculous situation of beggar your neighbour, and the only people laughing are the multinationals who pay corporation tax. The rest of us either pay more tax or we will have people abusing the services or whatever. That is a simple matter of mathematics. I have always been sceptical about whether cutting corporation tax would make a big difference. There is no way that the other side will not retaliate. That is what happens when you turn your trading partner into a competitor.

In relation to income tax, it is interesting that, as you know, the Scottish Parliament has had power to raise income tax by 3 pence since we set it up in 1999, but no party has ever advocated that we do it. From 2016, the Scottish Parliament will have the power and indeed will be required to set the income tax rate. Will it do something different? It might do because it might be a political point. On the other hand, it might say that for all that you get out of it, why add another complication, for example, to a pension company that then has to do two separate calculations, depending on where the customer happened to live and hope that the customer has not moved too often between north and south of the border. I cannot forecast what they will do. All I will say is that if you start getting into tax competition with your next-door neighbour, it is not too difficult to see where it will end up.

Q578 The Chairman: Last week, as you may know from having read the transcript, Danny Alexander, in his evidence, spent a great deal of time speaking very strongly on the point that a Scottish Government, with its own debt, could face much higher borrowing costs than the UK and he gave a number of reasons. Do you share that view? As we are looking at the implications for the rest of the United Kingdom, do you expect the rest of the UK to face higher or lower borrowing if Scotland becomes independent?

Alistair Darling MP: First, it is interesting to note that, I think, Fitch, one of the credit rating agencies, was in it up to its neck when it came to certifying subprime mortgages. We have to take what they say with a pinch of salt. They tend to follow the markets rather than make them. That is worth noting. Fitch said that the rest of the UK would maintain its AAA rating. It passed no comment on Scotland. It did not say Scotland was lower, but just passed no comment. Others have made the point—I cannot remember which rating agency it was—that it would be unusual for someone new in the market to come in with a AAA rating. There are very few left with a AAA rating now. This is no criticism. You might be an exemplary country, in terms of what we expect you to do, but it is like opening your first bank account: you tend to have a rather modest overdraft facility so that the bank manager can see what your track record is and whether you repay things at the end of the month and so on. That is something that Scotland should take account of. You also look at how much debt you have and what is the term in which you repay it. The average maturity of the UK debt is 14 years; in most other countries it is seven years. It is why we are never at any serious risk of not being able to service our debt, even in the darkest days.

The other thing that people would simply have regard to is one of the things we were talking about earlier: what is your measure of last resort facility and what is your central bank and so on? There are a lot of unknowns here. The final point is that you can compare well
established countries, such as Germany, with the Netherlands or Finland, which people generally say run a tight ship in terms of their budgets, but which pay more than Germany does. So there is a premium, an extra cost, because they are smaller countries.

**Q579 The Chairman:** Do you see any way in which those costs of borrowing could be alleviated by actions that a future Scottish Government would take in the short term and the long term?

**Alistair Darling MP:** Were Scotland to become independent, the Finance Minister would have to err on the side of caution and prudence for some time, until there was a track record. You are probably aware of the debate in Scotland about the extent to which you can provide free this and free that in the face of a population that is growing old at an alarming rate. Our guess is that, as with any new bank customer, any new business or any new country—that is what it would be—it would have to bend over backwards to show that it is not a big risk. That would have repercussions on what you can do for the population as a whole, who may view things entirely differently, saying, “Why are you kowtowing to the money markets? Why are you doing this when we want you to spend more on this, that or the other?” Again, I would never argue that it is not possible; it is just that we should not go into this with our eyes half closed.

**Q580 Lord Levene of Portsoken:** Do you expect that, in an independent Scotland, the non-oil sectors might be weakened because of the enormity of the oil sector?

**Alistair Darling MP:** I do not think that it is axiomatic that that would be the case, but there is a long-running problem here. If you take the non-oil sector and, for this purpose, the financial services sector and manufacturing, we have some very good companies in Scotland and we have done extraordinarily well out of them, such as our start-ups, and there is a lot of innovation and invention coming out of Scottish universities. Historically, though, we have had a problem, as indeed has a lot of the UK, in getting them to go from that start to being something that employs a fair number of people and is well established. That problem is not unique to Scotland but, if you look at the make-up of the Scottish economy, the thing about oil that worries me is that no one knows when it is going to run out. There might be a move to the right whenever you are asked this question. By definition, it is going to run out one day or become so expensive that it will become less attractive; that is what happens when you are using something that is not renewable. It is also very volatile in terms of your revenues. This is another important matter: if we are going to grow the manufacturing sector, for example—the non-oil manufacturing sector—we need to be better than we are at the moment on innovation and invention, and it is UK research money that Scottish universities are using here. That is another issue; universities have to ask themselves, “Where’s that going to come from in future?”

**Q581 Lord Levene of Portsoken:** As a follow-up to that, in the event of an independent Scotland, bearing in mind the crisis that the financial services sector has been through, do you think that it would be even more difficult for the financial services sector in Scotland to keep its head above water if it were operating in an independent country?

**Alistair Darling MP:** I am not sure that I would agree with that. The health of the Scottish financial services sector, as for the financial services sector in the rest of the UK, will depend on people believing that there is a more robust supervisory regime than there was in the past and that they have put their house in order. Most financial institutions in this country, unlike in continental Europe, have done that. People can see them moving in the right way. What is troublesome to the Scottish sector is that people do not know who is going to be
regulating them and what the rules and regulations are going to be. If you asked people in the financial services sector, they would say, “Until we know what the rules are, we don’t know and can’t tell”. That is the problem.

Lord Levene of Portsoken: That was my point—who is in charge and what experience will they have?

Alistair Darling MP: I think Scotland would probably have to have its own regulatory regime, simply because the European Union—assuming that we want to join and were joining—required it to have it. You would have to invent something from scratch. Given what has happened in the financial services sector, and given the fact that RBS was very much a part of what went wrong, it is clear that regulating banks is not easy. Finding someone who understands what is going on is not easy. If the bank directors did not know what was going on, how can we expect someone who has just walked in off the street to know?

Q582 Lord McFall of Alcluith: Scotland has had a trade and current account deficit with the rest of the UK for a while now. If Scotland were to become independent, and given the geographical shape of the oilfields, do you think that that overall trade and current account deficit would continue, or could you see opportunities for there to be a surplus?

Alistair Darling MP: I do not know about a surplus, but the figures since devolution show that there have been years when Scotland has done better and contributed more and years when it has contributed less, although this is an inexact science and this analysis has not been done officially. It is interesting that the percentages pan out so that in some years you do better than others. For Scotland to be in surplus, it would need oil prices to spike. You would need sky-high oil prices with sky-high prices at the pumps. That obviously would not be a great position to be in. At the moment, both the UK and Scotland are running a deficit; that has been the case for a number of years and it will continue. Without North Sea oil, Scotland would be in a terrible state. I do not think that anyone is arguing otherwise. You might argue over exactly how much it gets, but let us assume it is getting what is commonly thought to be its fair share. The thing about oil is that it is terribly spiky; production fell by something like 10% in 2009. You are dependent on investment decisions being taken by Texans—not by people sitting here. Once the stuff comes out of the ground or out from under the sea, a lot of it goes abroad. It is a very volatile thing to have, although it is nice to have when it is doing okay. Like everything else, you need not to look just at one year, which the nationalists repeatedly invite us to do; they take one year that happens to be particularly advantageous for them. You need to look at the issue in the round. People say, “What’s the positive case for Scotland in the UK?” Being part of a larger unit means you are better placed to absorb the shocks that come from time to time. North Sea oil is about 1% to 2% of UK GDP but about 10% to 20% of Scotland’s, and those figures speak for themselves.

Q583 Lord Hollick: You discussed the challenges of an independent Scotland joining the European Union. Is there another option, which is to join the European Economic Area?

Alistair Darling MP: You could, but I do not know why anyone would want to do it. The majority of people in Scotland, and certainly the clear majority of businesses, want to be part of the European Union. Here is another thing. As a number of you around the table who have been Ministers will know, when you go to Europe you find that it is run by large countries, not small ones. That may be wrong and may not be what everyone would want—certainly they would not say so—but it is the case. Look at what is happening at the moment. Which capital would you go to if you were going to Europe and you wanted to get
something done? It is in the largest country. If I were a business in Scotland, I would take the view that so much of what I did was affected by Europe one way or another that I would want to make sure not just that I was sitting at the top table but that I had as much clout as Germany and France had. That is critical. Why on earth I would want to be in the EEA, I do not know.

Q584 Lord Forsyth of Drumlean: To go back to the issue of lender of last resort, since, as you pointed out earlier in your evidence, the Bank of England is effectively guaranteed by the taxpayer, why would taxpayers in the rest of the United Kingdom wants to lend money to a foreign country, which is what Scotland would have become? Why would there be a lender of last resort facility? To half answer my own question, given your experiences with the banks that were too big to fail and the relative size of the banks to the economy, would an independent Scotland that got into financial difficulty be too big to fail from the point of view of the taxpayers in the rest of the UK?

Alistair Darling MP: Dealing with your first question, I think that my answer was that the Bank of England could act as lender of last resort. Would it? I do not know. Suppose that some country came along and said, “Could the Bank of England please be a lender of last resort for our country's banks?” I suspect that most people in this country would say, “No, it can’t—do it yourself or find someone else.” Obviously, were Scotland to join the euro, the ECB would be the lender of last resort.

On the second point, I have heard the nationalists say two things. First, they have said the Bank of England would agree to do it if you paid a premium. That is a bit like saying to an insurer, “I’d like to insure my bank,” and them responding, “Have you made any claims in the past five years?” Well, RBS has made quite a hefty claim recently. The second point that they argue, and I see that they have managed to get some academic support for this, is that if a bank failed—say that RBS failed again—people would all chip in if it went down. In other words, the rest of the UK would chip in, the Americans would chip in and so on. All I can tell you is that, on the night of 7 June 2008, no one at all anywhere in the world rushed to chip in to bail out RBS, despite the fact that it had a very large trading arm in the United States and many of the losses that it made were there. Obviously the US Fed was immensely helpful in terms of liquidity support and tiding over; it kept RBS going for a whole afternoon when it got into trouble on that Tuesday. When it came to recapitalisation, though—I think that the recapitalisation figure is about 30% of Scottish GDP—there was no one queueing up to do it. As Mervyn King said, these banks are global in life but national in death. That is the way that things are, I am afraid. There is no point in hoping and saying to anyone, “Please sir, will you come and bail out my bank?”—they will tell you where to go.

Q585 Lord Forsyth of Drumlean: What about the point about being too big to fail?

Alistair Darling MP: As I said, in 2008 RBS’s balance sheet was only slightly smaller than UK GDP. Actually, in January and February 2009 when we had to give them some supplementary support, it was just a bit bigger than UK GDP. We can do that because people do not doubt our creditworthiness. The case might be different if you have a much smaller GDP. This is not a criticism of the country concerned, but the Irish and Icelandic examples reveal a lot. People would say, “I see that the Irish banks guaranteed every deposit. How much are the Irish Government worth? How much are their banks worth?” What happened was that the guarantees were worthless.
Lord Forsyth of Drumlean: The nationalists would argue that we have already done it with Ireland; we lent Ireland money and I believe that they are paying 6% for it. There is a precedent.

Alistair Darling MP: But that was after Ireland was bankrupted. Ireland just could not go on. It had help from the European Union, the eurozone, the OECD and the IMF. We gave it £8 billion, not least because if you put your money in the Post Office bank, not everyone is aware of the fact that it is in fact the Bank of Ireland.

Q586 The Chairman: We have got through a great deal of material. Are there any further questions or final points that you would like to put to us?

Alistair Darling MP: The only point that I would make is this, in reply to Lord Forsyth: the more pressure that can be put on both sides—both Governments, that is—to publish information, the better. There will always be contestability here and something special that we do not know, but it would be so much better if we all did. The past 24 hours in Scotland have been depressing beyond belief. If people do not believe what is being said to them by their politicians on either side, they are going to despair. That is the last thing that we want regarding the biggest decision that we have made in 300 years.

The Chairman: We very much agree with that. We had a discussion last week with Danny Alexander and Sir Nicholas Macpherson, the Permanent Secretary at the Treasury, on this very point. The Treasury is now doing quite a lot of work, and we have asked for a paper to indicate exactly what subjects it is covering and what the timetable is for publication. I hope that that will help our work as well as the wider public. We have got through an enormous amount of material at a rapid pace and managed to meet our deadline of finishing by 1 pm. I am very grateful to you. Thank you very much, Mr Darling.
WEDNESDAY 24 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witnesses

Professor Charlie Jeffery, University of Edinburgh, and Jeremy Peat, David Hume Institute

Q526 The Chairman: Good morning, gentlemen. Good morning, everyone. Welcome to the Economic Affairs Committee. This is the first time that we have had a meeting outside London and it is the 12th evidence session of our inquiry into the economic implications for the United Kingdom of Scottish independence. Let me begin by thanking the City of Edinburgh Council and its chief executive for allowing us the use of this splendid meeting room—I am grateful to all those who have helped to arrange it for us. We decided—in fact we have been going since about May—that we should make the subject of our inquiry this one: the economic implications for the United Kingdom as a whole. I stress the United Kingdom as a whole, because there are economic implications for the rest of the United Kingdom, as well as for Scotland, and these we have been exploring too. We have Members of our Committee who come from those areas but who are not here today.

The reason for this inquiry is that it is clear to many of us that there should be a full understanding of the economic implications of Scottish independence before the vote on the referendum takes place. When we began this inquiry, we as an economic Committee felt that there had to be a proper investigation of many of these issues in public. That is, to some extent, still the case. We are very anxious to explore these issues in detail so that everyone has a clear understanding of the economic implications. That is the purpose of our inquiry;
we are looking not at constitutional, political or legal issues, but purely at the economic issues—I stress, for the United Kingdom as a whole. So we have a fairly intensive two days. Let me begin by very much welcoming Mr Peat and Professor Jeffery for setting the sort of background for the whole of our two days’ inquiry. Is there anything that you would like to say, or would you prefer to go straight into questions?

Jeremy Peat: Lord Chairman, I have just one very brief comment. I welcome what you were saying about the importance of spending time now finding out what the issues are and exploring them. We have roughly two years before a potential vote, and it is important that that time be used for that purpose. There are many complex issues to be examined, some of which certainly I have just started examining and identifying. It is too early to look for answers to most of the questions, but it is by no means too early to start determining what the key questions are.

Q527 The Chairman: On that, I would say that now we are not only clear what the questions are—and we had a very useful session with Danny Alexander, the Chief Secretary to the Treasury, last week, which raised a number of the questions that we will be exploring in the next two days—but we are beginning to get some understanding of the implications pretty clearly, and that is the purpose of our inquiry. Perhaps I may start by asking you this: the SNP has said that an independent Scotland would continue to use sterling. I know it has sometimes not been clear exactly what the party’s view is about that aspect of the whole issue, and we have looked at four different options for the way that this could happen. What do you think would be the best currency option for an independent Scotland from a Scottish perspective, and even perhaps from the perspective of the rest of the United Kingdom?

Professor Charlie Jeffery: Thank you. The debate here is now dominated by that single option—if Scotland votes yes, it will use the pound sterling. That is an option that has attractions for the advocates of independence by providing a sense of reassurance and continuity, but I think it is probably also an option that has significant popular resonance. So I think in both senses, with a special emphasis on popular resonance—we perhaps all too easily lose sight of what citizens think and want—the pound sterling is the best option in an independent Scotland.

Jeremy Peat: I agree with that. There are a whole host of interdependencies between the economy of Scotland and the economy of the rest of the United Kingdom. That constitutes a very good reason, at least initially, for the maintenance of exchange rates to create certainty between Scotland and the rest of the UK, and hence continuing with sterling as the currency has advantages. But of course that leads to the key issues of how sterling can be retained and what that implies for other aspects of economic policies.

Q528 The Chairman: Can I come to one of the key issues? If an independent Scotland maintained sterling, it would have to be bound by a fiscal pact. Do you agree?

Jeremy Peat: If an independent Scotland retained sterling as part of a sterling currency area, then I am sure that there would be negotiations between the new Scottish Government, the Bank of England and the Treasury as to exactly what that meant in terms of constraints on the operation of fiscal policy and our policies in an independent Scotland. So, exactly what outcome would emerge from those discussions is unclear, but particularly given the eurozone crisis, it is increasingly clear that there would be a need for some agreement on constraints on fiscal policy in an independent Scotland, as part of a sterling union.

Professor Charlie Jeffery: Might I add a note to that? We have heard from the Scottish Government’s perspective some initial thoughts on how fiscal policy co-ordination might be
managed following a yes vote, but not yet in a great deal of detail. What we have not heard, and what we are probably less likely to hear, are the conditions in which the UK Government might approach such a pact. We are in a strange situation in the wider debate, in that the advocates of independence have a strong interest over the next two years in proposing terms under which independence might be operational. There is probably less incentive on the UK Government side to match that, given that that signifies a recognition that independence might happen. So we are probably likely to have a slightly imbalanced debate with more input in due course from the Scottish Government side and perhaps less reciprocal imagining of how this would happen on the UK Government side.

Q529 The Chairman: Have you had a chance to look at the evidence that the Chief Secretary to the Treasury gave us last week?

Professor Charlie Jeffery: I have not.

The Chairman: If you look at that, you will see that he put significant emphasis on the implications for the UK as a whole and, in particular, he draws attention to—as Mr Peat has done—the crisis in the eurozone, which has very real lessons, looking ahead, for this issue as far as Scotland and the rest of the UK are concerned.

Q530 Lord Tugendhat: Can I ask this question? I think that you would agree with me that the formation of economic and monetary union and the single currency in the eurozone was perceived by the member states, first, as being irreversible and, secondly, as being a step towards closer union. It remains to be seen what happens, but those were two underlying assumptions and commitments. If we had a pact between a newly independent Scotland on the one hand and the rest of the United Kingdom on the other, surely we would be in the reverse situation. Scotland would have broken off from the United Kingdom, so, whereas the continental countries were coming closer together, in this case Scotland and the rest of the United Kingdom would be going further apart. In view of the fact that the whole drive for independence, as I understand it, is posited on the assumption that Scotland would be able to run its affairs better alone than as part of a United Kingdom, the assumption of outsiders would surely be that, far from being irreversible, this was a temporary accommodation until Scotland could do something of a more independent nature. So it is the mechanisms of the eurozone with all the difficulties that that implies, but, oddly enough, going in the reverse direction.

Professor Charlie Jeffery: You point to a very interesting contrast, which suggests that we are in unprecedented territory in considering the possible arrangements of the relationship that an independent Scotland would have with an independent rest of the UK. I would add a qualification to your sense of inevitability and irreversibility in that process, in that in Scotland and in other places around the world—advanced democracies which have pro-independence movements—the vision of independence is highly qualified, involving high levels of continuing partnership between the successor states of the current state. That sense of inevitability of moving ever further apart is not one, I think, that will be shared by proponents of independence here or in Quebec, Catalonia or the Basque Country—to name the most obvious examples. So irreversibility is not necessarily the constitutional imagination in these places and in Scotland.

Lord Tugendhat: I take that point, and I share the view that you have just stated, but if one is trying to look at it from the point of view of markets, the eurozone was given a lot of leeway by markets for a long time because it was presumed that it was irreversible and a step towards closer union. The point that you have just made is one that an independent
Scotland and the rest of the United Kingdom would have to convince markets of, because it would appear to run contrary to what the earlier debate had been. So there is a difference between perception and reality.

Q531 Lord Forsyth of Drumlean: Professor Jeffery, everyone says that there would have to be some kind of fiscal pact. This was decided when we embarked on European monetary union and we had the so-called Maastricht criteria, and Germany and France were the first to break the Maastricht criteria. The goalposts kept being shifted and we have ended up now with a crisis that is afflicting Greece and the other southern European countries, including Italy. If there is a fiscal pact between an independent Scotland and the rest of the UK, how exactly would this be enforced? How could you make sure? “Fiscal pact” is a technical term, but what it means is that the amount of money that Scotland is able to spend and borrow would have to be agreed with Westminster. I cannot see what mechanism would exist to ensure that that would be delivered and be effective. I remember during the 1990s the SNP running a very effective political campaign, when interest rates were being put up to squeeze out inflation, saying that Scotland was suffering from the overheating of the south-east and interest rates were being set to reflect the conditions there. If an independent Scotland was to have the pound, interest rates would be set literally to deal with the conditions south of the border. It is not clear to me what the mechanism would be whereby a Scottish Government would be able to influence the amount that they were able to spend and borrow and the interest rates that were being charged. If that is the case, would we not be considerably worse off economically in terms of the operation of the economic levers? I hope that that is not too much of a loaded question, but it is a genuine puzzle for me that the proponents of this idea of using the pound have so far have not explained.

Professor Charlie Jeffery: I may pass on to Jeremy to follow up on this point. The heartland of the issues is the kind of agreement that would be negotiated between the two Governments and ultimately whether that agreement was sufficient to maintain credibility in international financial markets. The discussion around that and market reaction around that would, I imagine, have some focus on the conditions and compliance mechanisms around those conditions. I suspect that, if those compliance mechanisms were insufficient, they would then express their views in ways that we have seen elsewhere.

Lord Forsyth of Drumlean: Forgive me interrupting you, but I am not asking about the mechanics of how you would do it; I am asking about how it would be enforced. In the European Union, for the euro, the enforcement mechanism is fines being imposed by Brussels, but it is not clear to me how you could enforce such a fiscal pact here.

Professor Charlie Jeffery: That again would be a matter for the two Governments in setting up the founding conditions of a sterling area of which an independent Scotland was to be a part. I cannot foresee what those conditions would be or what the particular negotiating positions of the two Governments would be in setting it up.

Lord Forsyth of Drumlean: But you recognise that there would have to be a stick with which Westminster could beat a Scottish Government if they were to depart from the agreed fiscal pact.

Professor Charlie Jeffery: I am sure that they would not use that terminology, but I think that, for credibility’s sake, both parties—not simply the Scottish party—would have to agree to particular limits and the way that those limits would be policed.
**Q532** The Chairman: John Kay was giving evidence to us earlier and he suggested that you could have a looser fiscal pact if the following three principles were established: first, that the Scottish Government could borrow; secondly, that the Scottish Government would be responsible for their own debts; and, thirdly, that the English Government would have no liability whatever and that it would be clear to people on the international markets that it had no liability for the debts of the Scottish Government. Would you agree?

Professor Charlie Jeffery: I would defer to Professor Kay's expertise in these matters.

Jeremy Peat: Can I just answer the points that have been made? First, on the initial establishment of the European single currency area, it is clear that it was critical that it be seen to be irreversible, but unfortunately there was not full adherence from the start to the pre-announced Maastricht criteria. One of the biggest problems to me was the debt-to-GDP ratios of several member states, which were assumed to be close to the level that was permitted when they clearly were not. That set in hand the risks that followed. Having seen the risks that resulted from country after country entering with high levels of debt-to-GDP compared to the Maastricht criteria and the strains that that imposed, I think that all countries contemplating anything akin to that will be more cautious in the future. I think that this is a different circumstance, as has been pointed out, from that particular arrangement, but there are lessons that can be learnt as one goes forward and will no doubt be learnt.

So far as how one manages any fiscal compact is concerned, I, too, always listen very carefully to what Professor John Kay says and take great care about taking issue with him. What would be of most concern would be whether any excess debt in Scotland put at risk the stability of the financial system and the economy across the UK. The criteria that John set out, if implemented, would tend to diminish the risks of such instability and disruption. At the same time, one has to remember that the UK Government have conditions and their own fiscal terms that they have set in the past and the present. They have set up their own means of monitoring those through the Office for Budget Responsibility, which is charged with giving advice twice a year on whether the UK Government, on existing policies, are set to meet their two objectives. I see no reason why there could not be arm’s-length examination of whether a Scottish Government were meeting any requirements that had been agreed in the draft just as the UK Government have the examination from the OBR. That would lead to the complexity of what tools one had in order to cause change to any Scottish Government policies, but the same arm’s-length examination would at least provide information for those Governments as to what was likely.

Finally, on the point about interest rates, Lord Forsyth is quite right that the interest rate would be set to the interest of the rest of the UK. At the moment, the Bank of England looks at the interest across the UK, but if we were in a different situation, with the rest of the UK running its policies and Scotland latching on somewhere within the union, there would not be the same explicit recognition of the issues across Scotland as there is at the moment. The impact on interest rates of conditions in Scotland is relatively limited at the moment, so I do not think that it would be a major change. Scotland has a very similar economy at the moment in many ways to that of the rest of the UK.

The Chairman: We will come on to that, because Danny Alexander would disagree with you. He was very explicit about the dangers of higher interest rates in Scotland. I understand that Professor Jeffery has to go at 10.50, so we will move on.

**Q533** Lord Levene of Portsoken: Clearly, it seems that there are only two options: one is to remain with some kind of link with sterling, whatever arrangements are made; the other is to join the euro. In relation to the second option, do you know whether any
calculations have been made about what it might cost Scotland to be in the euro? If we look at what has happened recently in the euro area, we can see so many problems. There are recipients and there are contributors. Has anybody calculated how much it might cost Scotland, if we take today’s economic situation? Would Scotland be a Greece or a Germany?

**Professor Charlie Jeffery:** Let me have the first go at that. We have learnt in the newspapers today that we have not yet had a full exploration of many of the issues around the European Union and I am not aware of any calculations of the costs and benefits in any detail. However, I think you are focusing at least in part on the rebates that the UK has defended and will be seeking to defend in the upcoming negotiations. If the rebates were applied in some way to Scotland, it would be an easy calculation to make. That is because Scotland is more or less bang on the UK average on most economic indicators. The big question is: what would the terms of an independent Scotland’s membership of the EU be and would that particular benefit be extended to an independent Scotland? We are not in a position to provide a full answer to that question, although I would like to hazard an opinion, if I may, on how the question of Scotland’s EU membership might proceed.

We have heard a lot of commentary about legal opinions. There are legally informed viewpoints which suggest that Scotland would be an equal successor state to the rest of the UK, and there are other legal viewpoints that Scotland would not, and would have in some way to seek EU membership afresh. Adjudicating between those viewpoints will be a major enterprise for academic and other lawyers over the next couple of years, but ultimately I think that the law will be one part of that discussion and politics will be the other. I say that for a number of reasons. First, it would be very hard against the EU’s own criteria to suggest that Scotland would be a problematic member in terms of the Copenhagen criteria on democratic governance and in terms of compliance with the acquis communautaire. If Scotland had experienced a referendum in which the advocates of independence were saying that Scotland should be a member of the EU, and if that referendum produced a clear result, that would produce a certain momentum for the EU to recognise that result. I do not mean necessarily that it would confer automatic membership, but certainly there would be an expectation of negotiation bilaterally between the Scottish and the UK Governments, trilaterally involving the Commission and multilaterally involving EU partners. They would set the terms of Scotland’s membership, including questions about the rebate. I do not think that Scotland would ever leave the EU, but I think that there would be a period of quite difficult negotiations on establishing what the terms of its membership would be.

**The Chairman:** I am afraid that time is getting short and we must move on.

**Q534 Lord Levene of Portsoken:** Historically, Scotland, and Edinburgh in particular, has always been a major and very successful financial centre, although of course recent events have put a dent in everybody’s reputation in that respect. Would an independent Scotland limit the size of financial institutions which could be headquartered there, as its tax base would be too small to bail out a large failing firm? That is because it is clear that, in past years anyway, Edinburgh was punching well above its weight. What regulatory arrangements would you want to see for large systemically important financial institutions, such as RBS, which headquartered in Scotland?

**Jeremy Peat:** I think that it is as yet uncertain exactly how arrangements might pan out for regulation, for lender of last resort and for catastrophe cover, if you like, for financial institutions within the context of sterling if Scotland remained within the sterling area. I think that that is one of a set of issues that would need to be debated. There is an indication, or a statement, that the expectation is that the Bank of England would remain the lender of last
resort, but again arrangements would have to be made as to how the apparently different regulatory bodies would operate so far as Scotland is concerned. If Scotland was a member of the EU within this context, there is again the question of how EU regulations would apply: whether it would be necessary for Scotland to have its own financial services regulator as part of its membership of the EU; whether it would need to have its own independent central bank as part of that requirement; and how the interactions would take place between the Bank of England and the regulators down south and any bodies that existed in Scotland. That is a complex nexus which I am afraid I am not at the moment sufficiently qualified or informed on to say much about. But certainly the question of scale would apply, at least until such time as there was clarity on exactly how regulation would apply and how cover would be there for the last resort lender and for dealing with any catastrophic risks. I am sorry not to be able to say much more at this time, but it is very complex.

**Q535 Lord Levene of Portsoken:** Can I just put in a supplementary question that occurred to me while you were speaking? If Scotland were to join the euro, and RBS remained primarily a major bank in sterling, how would that match up in terms of support from the Scottish Government?

**Jeremy Peat:** The question would be whether RBS then became a rest-of-the-UK headquartered bank or a Scottish bank, and likewise for HBOS or any other financial sector institution. Even within a sterling union, these financial institutions would need to make a choice as to whether they were based in the rest of the UK with their main regulation and relationships being south of the border or whether they wished to be global UK bodies headquartered in Scotland, and then dealing with the regulation and other matters that are primarily fed through Scotland. I know from talking to colleagues at Scottish Financial Enterprise and elsewhere that they are trying hard to work through the different issues related to this not only so as to provide advice for their members, but also to try and get answers to exactly how some of these different aspects would work. They are making some progress and they are just beginning to unravel some parts of the complex web that this is.

**The Chairman:** We will return to that point with later witnesses.

**Q536 Lord McFall of Alcluith:** I would like to look at the issue of fiscal policy. In a paper for your institute, Jeremy, David Bell and Bob Elliott stated that “it is realistic to assume that monetary union would also entail co-ordination, if not integration, of fiscal policy. Therefore, an independent Scotland would have no command over one major instrument of macroeconomic policy, monetary policy, and limited control over another, fiscal policy.” Do you agree with that and could you expand on it?

**Jeremy Peat:** I think this goes back to the point that we discussed earlier, which is, with Scotland remaining in a sterling union with the rest of the UK, whether the fact that it was relying on the Bank of England for the setting of monetary policy, and to some extent for financial sector regulation, matters.

**Lord McFall of Alcluith:** I think that what I am getting at is the response given last month by Alex Salmond in Chicago. He said, “We can have plenty of room for manoeuvre within a currency union.” That is the point I am getting at.

**Jeremy Peat:** There is plenty of room for manoeuvre, but it is not necessarily over the aggregate aspects of fiscal policy. There is plenty for room for manoeuvre to set separate corporation tax rates and income tax rates, subject to any constraints that the EU may lay down. There is plenty of scope for having a different allocation of public expenditure on different components. There is certainly choice between going for different regimes on all
aspects of taxation. But there will be an overarching constraint of some sort with regard to the aggregate fiscal policy. There was already a great deal of devolution on some taxation and there was a great deal of devolution on micro policies.

Lord McFall of Alcluith: Does this fit in with his comments to Andrew Neil in March, when he said that there is a need for a fiscal stability pact?

Jeremy Peat: The fiscal stability pact would be part of the agreement, as I understand it, between the UK Government, the Bank of England and the Scottish Government as to how the currency union would operate. But within that context, as I said, there is a great deal of ability to vary individual taxes and indeed to operate the public finances independently, subject to an overarching constraint or two as to the overall fiscal position and the sustainability of that position.

The Chairman: That is the crucial point—the latter part of what you were saying.

Jeremy Peat: The sustainability?

The Chairman: Yes.

Jeremy Peat: Yes, but this is the other complexity: no one has mentioned oil yet. You may be coming to that. But if one looks at the present position and allocates, for example, a geographical share of output from that sector to Scotland for GDP purposes and a geographical share of tax revenue to Scotland for its revenue purposes, you get a very interesting picture. If you look historically at how, on that basis of allocation, the public finances of Scotland have varied compared with the UK’s, you can see the very great sensitivity to oil prices. Looking forward, there will be great sensitivity to both oil prices and the volumes of oil and gas produced. I am always careful about forecasting this because when I came to Scotland in 1985 to work for the Scottish Government, I was told that one of my first tasks would probably be to deal with the impact of the run-down in North Sea output on Aberdeen and the north-east of Scotland. Well, that was a long time ago. I do not know what output or oil prices are going to be, going forward, but I know how sensitive the Scottish public finances will be to those matters.

The Chairman: Our next session will be on that very issue.

Q537 Lord Hollick: If Scotland votes for independence, the question you just posed of how you divide the assets up becomes absolutely critical. Oil is one thing, but there are other assets and liabilities. In the context of liabilities, one point that Danny Alexander made last week was on the much faster rate of ageing in the Scottish population, which obviously leads to significant additional pension liabilities. As you think about splitting or carving up the cake, what in your view are the key issues and problems that have to be addressed from the point of view of establishing a viable, independent Scotland?

Jeremy Peat: If I could start on that, I would commend to you two papers that we produced in the David Hume Institute. Lord McFall has already quoted from one, Public Sector Remuneration in Scotland, which also covers pensions and related issues, with David Bell and Bob Elliott contributing and a number of others including STUC. That is an indication of some of the key issues. The other is our first attempt to look at the allocation of debt and, to an extent, assets, which we produced in March 2012. We tried to identify there a framework within which one can look at the type of issues that you are referring to. But, yes, in addition to the sensitivity to how oil prices and outputs impact on revenues and indeed on the economy more generally, there is the demographic issue. The data there suggest that the dependency ratio in Scotland—the ratio of those in employment to those
outwith the normal working age—will be adverse as compared to the rest of the UK over the next 20 years, but again that is dependent on those forecasts being accurate. It also depends on what happens on migration. At the moment, there are constraints on migration which exist from the UK Government. Scotland as an independent nation might be able to have its own policy on migration and might wish to take a different view as to how it could partially offset the risks of an ageing population by attempting to attract a more vigorous, younger group—possibly from those who are coming to Scottish universities in great droves. They might be tempted to stay on and participate constructively. It could be that if one goes down that road, it would lead to another major source of dynamism within Scotland.

Q538 Lord Forsyth of Drumlean: I am aware that we are short of time, Lord Chairman, but could I go back to the lender of last resort and the position of large financial institutions such as the RBS? You said that it was not clear whether the Bank of England would be a lender of last resort to an independent Scotland. I cannot for the life of me imagine why the Bank of England, which the taxpayers in the rest of the United Kingdom stand behind, would want to be a lender of last resort to a foreign country, which is what Scotland would become. For large organisations such as RBS, faced with the choice which you pointed out between being based as a company in the rest of the UK or being based in Scotland—with the likelihood that the costs of raising capital for those institutions based in the rest of the UK would be considerably less than if they were based here in an independent Scotland—why would such large organisations not make that choice? In all the arguments about this being terribly complex, is it not very simple? It is highly unlikely that English taxpayers or those in the rest of the UK would want to be a lender of last resort, or that these large financial institutions would wish to remain headquartered in Scotland, because of the cost of capital.

Jeremy Peat: If I could start off with one point that you made en passant, I do not think it is clear at this stage that the cost of borrowing for Scotland as an independent entity, or for financial institutions in Scotland, would necessarily be significantly higher for a continuing period than in the UK. It all depends, as ever.

Lord Forsyth of Drumlean: So you disagree with the evidence that we got from the Permanent Secretary at the Treasury last week, who said that it would because Scotland would not have had a track record?

Jeremy Peat: I referred to it being over an extended period. I think it will be necessary initially to establish the track record. However, I have looked at the terms and conditions that Standard & Poor’s and Moody’s apply and they would have to see whether they could, in a relatively short period, establish the credibility of the regime in such a way that its rating was similar or close to that of the UK. Whether that would be achieved and how long it would take for that to be achieved, I do not know. The issue is how they would set out in a whole host of areas in order to establish credibility—and establish a rating that meant that the cost of borrowing was as close to that of the rest of the UK and other AAA-rated economies as it could be. To an extent, the rating of any companies based in Scotland would follow from that, although there are instances where companies can have a higher rating than their country. Some companies retained AAA-rating when the US was downgraded, so there is a link between company rating and country rating but it is not an absolutely firm and fixed link. This is one of the many imponderables.
Yes, there would be scepticism from the outset as to the rating and what the cost of borrowing would be. Yes, there would be uncertainties; I would never disagree with the Permanent Secretary to the Treasury that, at least for the initial period, the tendency would be for the cost of borrowing to be higher. That does not mean that it would be in a sustained period. Scotland would have a GDP per head that was higher than practically every region in the rest of the UK, if oil and gas activity was allocated on a geographical basis. There would have to be a view taken on whether it had policies that were going to lead to higher growth and to a strong economy, going forward, and whether companies within that economy would operate well. All of that will be determined by what happens not just over the next two years but over the next several.

Q539 Lord Tugendhat: Professor Peat, you said that in 1985 you were being asked to look at the implications of the rundown. I can match that in a sense in that I wrote a book about the oil industry in the late 1960s, when the world’s official reserves were supposed to last for 20 years. So there is a lesson in that; oil reserves are rather elastic. My question is about whether you think that Scotland might become overly dependent on the oil industry. I ask that in this context—that in an uncertain world, one thing that seems reasonably certain is that North America will have energy self-sufficiency within a reasonably short time. That is going to have a profound effect on the history of international oil prices. Then there is the question of shale gas, not just in England but in other European countries, which will potentially lead to a very significant diversification of gas supplies. In those circumstances, what do you feel would be the nature of the Scottish economy’s dependence on oil, accepting your assumptions about what the division of resources would be—which might not be the case?

Professor Charlie Jeffery: I think that you raise a challenging question in a number of ways. First, we do not know what energy production patterns will be and therefore we do not know what the price of the oil produced or the effect on the Scottish budget would be. They all appear to me to be risks that any competent Government would wish to mitigate by taking steps to diversify the economy of Scotland. One obvious area that interconnects with all those areas of oil and shale and fracking and so on is that of renewable energy. Scotland has a lot of wind and a long coast and places where tides get pushed through relatively narrow gaps. That is one area where the current Government, or any Scottish Government, would be looking to boost economic activity both in the production of energy and in the exploitation of power. Jeremy Peat has pointed to other areas. Scotland has outstanding universities, relatively speaking, in the various global league tables that are produced. That offers enormous potential as an export industry in itself and as a means to attract talent to Scotland to help to develop the economy in various ways. But I think that that diversification is an essential point that any future Government of an independent Scotland would have to prioritise.

Q540 Lord Tugendhat: Can I just backtrack? Scotland has a great many assets; it has a great many actual industries and it has potential industries. The point about universities is well taken, and we all know about Silicon Glen. I agree with all that, but oil has loomed very large in the independence debate over the years, yet it seems to me that the independence referendum is coming at a time when the balance of power in the energy world might be shifting in favour of consumers, with the downward pressure on prices, principally because of the extraordinary events in North America. Once North America ceases to become a major importer and becomes an exporter, the effect on energy prices is likely to be downward for quite a long time.
Jeremy Peat: If I could just add a comment or two on that, it is important that the Scottish Government looks at the story on the public finances and the story on the wider economy in the context of different scenarios for the energy future. You have put forward one plausible scenario, with the balance of power shifting for the consumer, with all prices tending to fall and having an adverse effect on revenues and activity. That is certainly a plausible scenario, but I have been in this game long enough to know that there are other plausible scenarios. Given the sensitivity of the public finances to this issue, I would wish there to be another story told, looking at the implications for different sources of revenue with the need to revisit decisions on public expenditure, in the context of alternative views of the world. It is not a matter so much of what happens in the next 12 months as what happens over the next 10 years that really matters. It is very important that Scotland does not become overly dependent on any one sector; we are already seeing imbalances within Scotland, with very low levels of unemployment and a high demand for labour in the north-east, and a very much higher GDP per head there compared with that in the west central belt, for example. That is an imbalance that is difficult to manage at times.

Going forward, I do not think that we should neglect the great possibilities of the oil industry for other territories and other activities. There are huge skills that have been developed and very strong companies that can sell their services and are selling their services globally. So I would look for diversification in using those skills in addition to focusing on the very strong industries that we have within Scotland. There are some very competitive and dynamic Scottish companies, but not enough of them, and there are very successful Scottish companies, and I would look for a means by which several sectors could develop to be as effective and internationally competitive as we are seeing already with one sector. We need that diversification, with an examination of the wider economy and public finances.

Q541 The Chairman: The timescale that you suggest is very interesting—it could be five or 10 years, but it could be a very tricky period, if receipts from oil declined significantly. Would that mean constraints on other areas of public expenditure, if the diversification was not fast enough? Secondly, would you be in favour of an oil fund to build up the public assets for the times at which they were depleted even further?

Jeremy Peat: Those are two difficult questions. I was very much in favour of an oil fund 30 years ago, when the oil fund option would have worked. At the moment, it is difficult to see how funds could be allocated of substance from the existing public finance arrangements for several years to build up a fund. I would not say that it is impossible, but it would involve even tougher choices on aspects of public expenditure than we are facing at the moment. There could be a tough period of years, if one had a very sharp decline in the oil price, leading to a very sharp decline in oil and gas revenues. The figures that I have seen suggest that that would have a significant immediate impact on public finances in the years in which it fell. So we would then be dependent on what any agreement was with the UK authorities as to the fiscal compact, or whatever one has, on whether there is a degree of flexibility to allow for changes over time. Any sharp year-on-year requirements would be extremely difficult, but I would expect, just as the present UK Government are seeking to reach a certain position by 2015 or 2016 or whatever, that there would be a degree of inter-year flexibility. It would certainly make the position much tougher if the oil price fell sharply. It would be much better if the oil price went up again.

The Chairman: Professor Jeffery, I understand that you need to go.

Professor Charlie Jeffery: May I make one comment before I do? It is about the question that has been raised about the fiscal pact, and whether it contains such flexibility to manage
short-term volatility. It addresses Lord Forsyth’s questions about why the English or the rest of the UK would ever want to offer these services to a foreign country. I think that the answer to your question about the fiscal pact depends on how far the UK will see an independent Scotland as a foreign country. Would it be a foreign country in the same way that Bulgaria or Zimbabwe are, or would it be a different kind of foreign country? It is really a reiteration of my first point about this notion of independence with partnership which the Scottish National Party and others elsewhere have. The question is whether that notion would be reciprocated by the UK Government following a yes vote, on the basis of shared history and so on. My suspicion is that it probably would be reciprocated to an extent, although that is something which we cannot foresee. I do not think that the UK Government are likely to tell us at this stage until they have a yes vote in front of them.

**Q542 Lord Tugendhat:** Certainly I agree with you that there are gradations of foreignness, and Scotland would not be a foreign country in the same way as Bulgaria. But, with great respect, you are sliding over one difficult point and that is whether the taxpayers would want to stand behind foreigners, however close the foreigners are. After the separation by choice of the Scottish people, would the remaining British taxpayers feel that they should stand behind the people who had separated?

**Professor Charlie Jeffery:** Very briefly, there is already quite a bit of evidence that many taxpayers, especially in certain parts of England, feel that current arrangements are not as fair as they might be. I cannot imagine that that situation would change in an ameliorative way if Scotland became independent. So while I am saying that some of the notion of close partnership might be reciprocated, I do not think that that would mean an easy ride. I do not think that it would mean a lack of tough negotiations. I do not think there would be a UK Government free to negotiate such arrangements without taking into account public opinion, which would envisage Scotland in a different way if Scotland chose to be independent.

**Q543 The Chairman:** I do not think that we have time to go into the Barnett formula, but thank you very much for coming, Professor Jeffery. I know that you have been under great time pressure. Mr Peat, do you want to comment on this before we turn to other questions?

**Jeremy Peat:** I just want to add one last comment. My understanding is that, under the new crisis management which has been established, or is coming to fruition, if England has operational responsibility for the crisis it will be the UK Government that have to make the crucial decision to apply public funds. It is quite interesting as to how the UK Government would determine if a Scottish-based institution was in difficulties and needed support. It would be their decision explicitly as to whether the funds were applied, rather than the Bank of England’s. That adds to the interest of the issue.

**Q544 Lord Hollick:** Mr Peat, you have mentioned on a couple of occasions what we might call the dynamic potential of the Scottish economy. You have referenced the possibility that it might have a different immigration policy, which might bring younger and possibly more entrepreneurial folk into the country. What could an independent Scotland do that it cannot currently do as part of the United Kingdom to promote faster growth and greater entrepreneurial activity in Scotland?

**Jeremy Peat:** It is a very interesting question. I think that a great many of the levers of microeconomic policy have already been devolved to Scotland at any rate. The question is whether the establishment of an independent Scotland would, first, add some extra powers such as potentially setting rates of corporation tax, a different migration or lower regulation
in some areas—whatever there may be. Also, there is the question of whether the mere fact of independence might lead to an inflow of expatriate Scots with capital who might wish to invest in their newly independent country. They could be new dynamism coming in, and there could be other features which would create a different dynamic within Scotland. I have not seen this explored carefully and rigorously and I hope that, as part of the further examination which ESRC will be supporting and others will be doing, some of these issues can be more carefully and rigorously addressed than I could hope to do at the moment. It is a critical question as to whether there are changes, impulses and regimes that would be possible under independence which are not possible now, and whether there would be other changes in the environment that would lead to the potential for a faster growth rate in Scotland than has been the case in recent years.

Q545 Lord McFall of Alcluith: You mentioned the popular view and the popular will. What do you think that this referendum will revolve around? What theme do you think that will be?

Jeremy Peat: I am not qualified to judge on that. I am not a political scientist, as Charlie Jeffery is. Secondly, it is far too early to judge. We have just got a little bit beyond the phoney war, and I think we are now going to get into the evidence-based discussion. I want to lay emphasis on the David Hume Institute and other contacts really enhancing the evidence-based information that is available, transparently, to all people who will be making a decision. We have to spend the next 18 months getting that right, and that is utterly important for getting the right decision, whatever that may be.

The Chairman: We share that view, which is why we are doing this inquiry.

Jeremy Peat: That is why I welcome it.

Q546 Lord Forsyth of Drumlean: Going back to the importance of North Sea oil revenues, Professor Rowthorn from Cambridge gave us some evidence that there is concern as to whether Orkney and Shetland would wish to remain part of an independent Scotland, or whether they would go with the rest of the UK. Depending on how you divide up the oil revenues, they would get about 30% of the revenue, so there is obviously a huge financial incentive for the people of Orkney and Shetland to stay with the rest of the UK. How practical do you think that would be, or how likely is it that they might take that view?

Jeremy Peat: I find it somewhat unlikely that it would happen. When you are talking about higher interest rates in the UK causing problems for Scotland in previous years, I remember that there were people underneath who argued that it was all Edinburgh’s fault. You have this difficulty of geographical differences that emerge. We have enough on our plate looking at the issue of an independent Scotland without going beyond that to whether the Northern Isles would separate as well.

Lord Forsyth of Drumlean: There has been some comment from the political representatives in that part of the world and elsewhere. If the argument runs that Scotland would so much better off with the oil, then for Orkney and Shetland it is squared, is it not?

Jeremy Peat: I can understand that position, and of course Shetland did establish an oil fund, which has been very effective in dealing with issues there. I can understand the issue but, to me, it is not yet on the agenda. I have got enough to do in trying to help analyse the issues that we do have on our agenda without going beyond it at this stage.
Q547 The Chairman: We have covered a lot of issues. In conclusion, are there any other major possible benefits or disadvantages of an economic nature that we have not covered?

Jeremy Peat: I think that you have covered the key ones. We will be looking at some of the macroeconomic and regulatory issues in the first element of our work. We will then look at options for different means of delivering public services of different types, and whether there is more flexibility or a different approach that could be developed. We are then going to look at the energy sector and all of the issues there. We have touched on most of those features. I think that the real unaddressed issue is what could change the dynamics within Scotland, which I would rather was not just a matter of rhetoric but was preferably founded on some consideration of what had happened in other small economies that had been successful and other small economies that had not been successful. We need to learn more from those examples. We need to consider what could be achieved, as Lord Hollick was asking, in wanting to move in that direction. There is plenty on the agenda. We are making some progress and I think that we will continue to do so.

The Chairman: Mr Peat, thank you very much for giving us a very interesting and helpful start to our two days. We are most grateful to you and will look forward with interest to seeing what further work you do on some of these issues. Thank you very much for coming.

Jeremy Peat: Thank you.
WEDNESDAY 24 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witness

Ruth Davidson MSP, Patrick Harvie MSP, Johann Lamont MSP and Willie Rennie MSP

Q587 The Chairman: Thank you all very much for coming. I think that you are aware that our Committee is concentrating only on the economic aspects of Scottish independence and the implications for both Scotland and the UK. We are not looking at any other aspects. I think that you are also aware that we feel that there is still insufficient debate about some of these major issues—I hope that our Committee’s inquiry can help to enlighten on some of them. Do any of you wish to make an opening statement? We have to rattle through, as you know, because we have four of you and a limited amount of time, but would any of you wish to make an opening statement or shall we go straight in?

Patrick Harvie MSP: Only thank you for the invitation to participate.

The Chairman: I thank Johann Lamont for the excellent paper that she gave us. It is a very well put together paper, which we had only very recently, but we have all had time to look at it. Thank you very much. Could I start then by asking what are the economic pros and cons to independence?

Johann Lamont MSP: First, can I just say thank you very much for the invitation to be here? Of course, the test over the next period will be for people in Scotland to answer what those economic pros and cons are. It is essential that that is a rigorous and thoughtful debate rather than assertion. I start from the position that Scotland can survive on its own. The question is whether it would be in the best interests of the people of Scotland. I feel very strongly that Scotland in partnership with the rest of the United Kingdom has been able to
have a strong economy. The rest of the UK is also clearly important in terms of being Scotland’s biggest market. We are part of a larger economy, which allows us to pool resources and to share them in tough times. It protects us from some of the financial shocks that might be experienced, and that stability allows us then perhaps to push forward Scotland in the United Kingdom. It offers a basis for economic stability and opportunity across Scotland in terms of the economy.

Ruth Davidson MSP: I thank the Committee for inviting me here today. I believe that if we look at the case for Scotland being an independent nation, it is not just a simple zero-sum analysis of the economics. It has a lot to do with our cultural and social history; it has a lot to do with our character as a nation and with our individual identities. In terms of the economics, though, as this is the particular element which this Committee is looking at, I have yet to see an economic case for independence and I do not believe that those who are espousing the separation of Scotland from the rest of the UK have made that case. When we look at Scotland within the United Kingdom, I believe that both Scotland and the rest of the UK benefit from being part of that union. In the stability of our banks and financial institutions across the UK and in Scotland, the role that oil plays in the Scottish economy, and the ability to service our debts at low interest rates and to borrow from foreign nations, you will see as we progress that there is a benefit to both Scotland and the rest of the UK from remaining in the union.

Willie Rennie MSP: I am Willie Rennie and I am leader of the Scottish Liberal Democrats. Thank you for inviting us to be here today. One of the fundamental problems with addressing this question is that no modern successful country in the past has broken itself up to become a smaller nation. It is perfectly possible to be a modern, successful, small nation—you can cite Norway, Sweden, Denmark and various others. The question is not whether you can be successful by being Scotland; it is whether you break yourself up if you are a modern successful country with the single market and the social equity that we have across the UK in order to become smaller. That transition in a modern world is extremely challenging. If you look at financial devolutions, these are much more complex than they were in past—for example, in the cases of Norway and Sweden. Welfare states were not as complicated as they are now. The transition process is really quite a difficult thing to come to terms with. You can cite eastern European countries, but they split from the Soviet Union when it was on its knees, so they are not exactly comparable. African countries likewise are not comparable. Sweden and Norway split before the issues became as complex as they are now—there is no rule for how you do these things, so it is difficult to say what it would actually look like. The issue is not independence; it is the transition to becoming independent which is one of the most challenging things.

I concur with what Johann and Ruth have said—there are significant benefits from being in the single market in the United Kingdom. We can trade freely; we can have social equity, so you can smooth the peaks and troughs in different parts of the country. When we have difficulty, we can organise around it; we can pass round the benefits of that. That is one of the great benefits of the UK. So that would be my case. It is very difficult to be absolutely sure whether we could do that as an independent Scotland.

Patrick Harvie MSP: I, too, thank you for the invitation to take part, which I hope reflects recognition that there is a small but growing faction of politicians in Scotland who support a yes vote but who are not part of the SNP. Like Ruth, I think that we should not be making a decision about this question of independence on the basis of the economy alone. I would hope that you would not expect the Green Party to advocate a position that places GDP growth on a pedestal—a big part of the reason why we exist as a party is to challenge that
notion. If we put other economic priorities ahead of that, such as tackling economic inequality, it is pretty clear that, from the beginning of the Scottish Parliament onwards, we have been unable to take a coherent approach to such issues because of a lack of ability to deal with the substantial aspects. We have responsibility for issues such as debt management, but we do not have responsibility for credit; we have responsibility for many of the effects of economic inequality but not for the structural causes. I would see an economic opportunity to put other priorities such as tackling economic inequality ahead of mere economic growth. But I would agree that no voter in Scotland, no policymaker—thinking about how they would manage the transition—and no politician should sell or buy a simplistic message like everyone will be £500 better off or everyone will be £500 worse off. Willie Rennie ended by talking about uncertainty. We need to face this question about Scottish independence and its implications in full recognition that everybody the world over is facing profound and unprecedented uncertainty and doubt in terms of economic crisis and ecological crisis. That will face Scotland whether we stay part of the UK or not. The pros and the cons will continue to be mixed whichever choice we make.

**The Chairman:** Thank you. Perhaps I should just say this for the benefit of the wider public. People may wonder why we have here for this session four leaders of political parties in Scotland, but not the leader of the SNP. We did invite Alex Salmond to come and give evidence to us separately. He has declined to do so and suggested that we apply to Mr Swinney, but he could not be here today. We are hoping to see him as a witness, but unfortunately we will have to hold our hearings in London. That explains why we have four witnesses.

**Q588 Lord Tugendhat:** For many years, the SNP has advocated the use of the euro as Scotland’s currency, but now it advocates the use of sterling. I would be grateful if you could tell the Committee which currency you think would be most appropriate, and about the advantages and disadvantages.

**Johann Lamont MSP:** In a sense, that is an answer that the SNP has to provide, but it has significantly failed to do so thus far. Those of us who advocate staying inside the United Kingdom recognise the strength of sterling and the strength of monetary and fiscal union at a time when everyone is highly anxious about the circumstances. Of course, in the past the SNP’s position was to be in the euro, but they now say that they would want to stay inside the sterling zone. But they have been unclear in which context. Would they simply assert this and then use the currency? If they do that, there are risks, because they then would not have a lender of last resort. They have of course said that they would enter into a compact with the rest of the United Kingdom on sterling, which of course would mean that a separate country would have very significant control over our monetary and fiscal capabilities. It is inconceivable that you would allow Scotland to be part of sterling and not demand that there be some coherence in relation to fiscal policy, especially if you are going to give a guarantee as a lender of last resort. So we are in a place where it seems to me that a separate Scotland in sterling would either simply be free floating, with all the risks that involves for ourselves, or it would go into an agreement with the Treasury and the Bank of England and be subject to constraints, at the same time as those bodies would not have to take into account Scotland’s particular interests in the decisions they make. My view is certainly that we would be in a weaker position than we are in now. For all the SNP’s assertions that Scotland would have a place on the Monetary Policy Committee and that that would be entirely acceptable, there is no evidence on that. There are very hard questions, which have to be answered around the implications and the nature of the agreement.
In March of this year, Alex Salmond said that of course there would need to be a fiscal stability pact, but he has also said as recently as in September when he was in America that we would not require a stability pact. There is a huge degree of vagueness around how sterling would work, what the consequences would be and the influence on Scotland’s needs and interests in the thinking of those who are making the political decisions around monetary and fiscal policy.

**Ruth Davidson MSP:** I may have been a wee lassie, but I actually go back further than Johann Lamont, and I remember a time in the late 1980s when Alex Salmond was espousing the Scottish pound to the House of Commons. So we have had three clear positions from the SNP in the last 25 years: first, for a Scottish pound; then to be part of the euro—certainly until around, I think, late 2009 it was advocating that—and now to have sterling and to operate in a similar way to Ecuador and Panama with the US dollar.

There is a question here that goes beyond what those who espouse an independent Scotland wish the currency of that nation state to be. The question is: is that within their control? We found out very clearly yesterday from events in the Scottish Parliament that the current Scottish Government have no knowledge, or certainly no legal advice, to back up an assertion that has been made for some months that they would be a nation state within the European Union. This has implications for the currency because if that is not the case and if a new nation state was built as a separate Scotland, and it had to be an accession state to the European Union, then that country would not have control over what currency it would have. That is because one of the rules for joining the European Union is that sooner or later you have to adopt the euro. There are huge levels of uncertainty surrounding what you spend out of your own pocket should a separate Scotland come into being.

There is one point that I would like to develop out of Johann Lamont’s testimony. Were it to come to pass in the current SNP model where we had a sterling zone between a separate Scotland and the rest of the UK, what protections would be in place for businesses and consumers? It is unclear from the model that we have from Alex Salmond and his Finance Minister, John Swinney, as to what protections there would be. Who would be the lender of last resort? Who would be the financial services regulator? Would there be the same protections for consumer savings over £85,000, which are the protections we have in the UK right now? Could they be extended to Scotland and, if they were, who would that body be? Is it even legal to have the Bank of England operating in the way that the SNP has suggested might be the case, in terms of being a regulator for some of our financial industries? So far as I am aware, every single European nation has its own regulator, including tiny Malta, and there is testimony from people who work high up in Scottish financial services saying that that this could be against European law. So there are huge questions surrounding the whole area and I am not entirely sure that they are questions to be put to the people who espouse Scotland remaining a full member of the UK. For those who have a prospectus to split up Great Britain—perhaps Patrick will be able to explain—these are the questions that the people of Scotland need to have answered before they can make such a decision.

**Willie Rennie MSP:** Ruth Davidson referred to yesterday’s events.

**The Chairman:** You could not avoid it.

**Willie Rennie MSP:** It is typical of the way that this has been approached. It is all based on an assertion. You will get different legal opinions from a variety of sources, depending on who you speak to. What is clear is that the Scottish Government are duty bound to look at the scenario of what would happen if Scotland was required to join the euro. So far, all they
have done is to say that they will continue with the pound and see how that will work. I am not asserting that we would have to join the euro, because that is yet to be determined, but what I am saying is that they have a responsibility and a duty to look at what would be involved in us joining the euro. What would be the requirement on the deficit? There is the requirement in order for us to join the euro that we bring the deficit down to something like 3% of GDP. Scotland’s is currently around 7.4%, based on Alex Salmond’s favourite figures. So we need a significant reduction in public spending, of the order of £5 billion. I think we need to explore that avenue as much as the SNP is exploring the avenue of sterling so that voters can go to the polls in a referendum with a full understanding of the possibilities. If we do not clear this up and get some clarity on what could happen—not what Alex Salmond says will happen—we could be leading the voters to the polls without full knowledge. As yesterday showed, we want to avoid an endless argument about the legalities of this. What we really need to do is to look at all the possible scenarios so that people are fully aware of what might happen.

Patrick Harvie MSP: I agree with Willie Rennie about the need to be clear about all the possible scenarios. To be clear, my preference would be that the scenarios would still include at least the possibility over the long term that a separate currency could be put in place. It is clear that that is not an immediate possibility any more than joining the euro would be the immediate preference of pretty much anyone in Scotland, I should imagine. One of the problems—it came up yesterday—is the question of automatically negotiating EU membership. My suspicion is that that cannot be properly interpreted until we know on what basis the referendum is going to be held. What kind of legislative process will we have afterwards in the event of a yes vote? It seems to me that understanding the emergent status in the process of independence needs an understanding of the legislation that we pass in the UK Parliament and in the Scottish Parliament in order to give effect to the will of the people of Scotland if they vote yes. Neither Government are likely to be in a position to begin to flesh that out until after the referendum. We need to be clear that all of these possibilities need to be developed, but none of them is likely to look like a guaranteed bet until the Governments are placed in a position where they have to negotiate on the basis of a mandate from the referendum. I am happy to acknowledge that, whether I was lucky enough to be the First Minister with the whole Civil Service to help me answer these questions, or a MSP from a group of two with a tiny team to help me. This is one of the hardest aspects of the yes campaign. I do not think anyone should pretend that, two years out from the referendum, we are in a position to know for certain what the position of the UK Government will be in the event of a yes vote. I think we need to know that in the long-term scenarios. Perhaps 10 or 20 years after the yes vote an independent currency might become possible, but it will probably take that long.

Q589 Lord Hollick: Mr Harvie, you raised the interesting notion that this is really a two-step process: there is a referendum on the principle of independence and then there is a period of negotiation which would then lead to a legislative process. Or do you think there will be another referendum? It seems to me that the great difficulty, to which all of you have referred, is that a lot of the detail of this will not be known until a negotiation has taken place. Therefore, the referendum in 2014 will inevitably be taking a view on how that negotiation might turn out.

Patrick Harvie MSP: Some people have made the case for a second referendum based on the outcome of the negotiation process. My only point was that that negotiation process will not begin until both Governments are faced with a mandate in the event of a yes vote. My point about democratic legitimacy would be around the development of a constitution in the
event of a yes vote. There would have to be a process of developing a constitution in as participative a way as possible. That probably cannot take place until people have dealt with the shock of the result and a new UK Government are in place, however many months after the referendum. The adoption of a constitution would be required before the transfer of powers could be undertaken. I would argue for a longer and slower and—I am crossing my fingers here—calmer process than the First Minister has in mind: the 16-month headlong rush from referendum to the transfer of powers.

**Johann Lamont MSP:** A great deal of the uncertainty has been developed not by those who have been asking hard questions about the consequences, but by the answers from those who have advocated for 40 years that Scots separate from the rest of the United Kingdom. That is astonishing. One might have expected that you might be able to answer some of these questions. To give one small example, in 2009, the Finance Secretary said that he would want financial regulation to come to the Scottish Parliament. In 2011, he said, “Well, perhaps it is a more complicated issue and really we need to look at this on a global and European scale”. Then this year he said that we would want the regulation to be the same as for the rest of the United Kingdom, despite the fact that there may be issues around the European Union. There is a very significant concern about the economic impact of independence. What is currently the economic impact of that degree of uncertainty? I was struck when I was preparing for this by the extent to which this will be a huge, long, complicated exercise or process that will take huge amounts of the time and energy of some of the best brains in the United Kingdom. I have one small example: When Czechoslovakia separated, it took them seven years to agree on the gold reserves alone, so one of the things that we need to ask is about the urgency and certainty. There are very basic questions around the currency and financial regulation. It is not about the normal to and fro of the political process; it is about the extent to which the energies of our political process will be drawn into something hugely difficult while the rest of government will not have a focus at all. There is a huge challenge. I hear what Patrick Harvie says about how we really cannot deal with all of this until we agree, but unless you know these things it is very difficult to see how people are afforded the opportunity to make a decision about something that is not reversible. The First Minister says that it will be the most significant thing to happen to Scotland in 300 years but that it will also result in very little change at home. Those things cannot both be true.

**Q590 Lord Tugendhat:** I have a very brief question. It seems to me that there is a real problem about having a referendum, then a negotiation and then a referendum on the conclusions. The Scots have a vote—we English do not have a vote—on separation, but if an agreement is reached between the two Governments, then the Scots could have a referendum, but we would have to have a referendum too about whether we accepted those proposals. I do not think that you can have a two-stage operation.

**Willie Rennie MSP:** Having a second referendum was explored previously, but people need to realise that once you have taken the decision to leave, you are gone. That is it. There is no turning back, no return to the United Kingdom. People must not think that there is a safety net.

**Q591 Lord Forsyth of Drumlean:** I wonder if I could just pick up on one point—I am trying desperately not to be partisan here. I thank Johann Lamont for the paper, which is very well argued and helpful. Based on what has happened in the past 24 hours, is there not a problem if you are living in Scotland and thinking about how you are going to cast your vote on this important question? There are a number of issues, such as the currency, our
position in the European Union and the rest, which are absolutely central and crucial, but if you think that the sources of information are either partisan or, even worse, untrustworthy, how do you form a view? You are all very much involved in the Scottish Parliament as leaders of your parties, but in my day, when I worked in the Scottish Office, I would say things and sometimes our information office, which was independent, would tell me off for being too partisan when I was acting in a government role. Do you have any thoughts or ideas on how we can ensure—particularly as this Committee is concerned with economic issues—that people can have sources of information on economic issues that are reliable and trustworthy, because it seems to me that the referee is wearing one of the jerseys at the moment?

**Willie Rennie MSP:** It has been suggested that there should be an equivalent of the Office for Budget Responsibility which would oversee and adjudicate on some of these economic issues. There would still be a debate within the figures, but if you at least have a foundation for the figures which we would could all understand and agree, there could be positions based on them. An Office for Budget Responsibility, independent of government, accepted by all the political parties as neutral, is a reasonable suggestion. There would have to be an acceptance and understanding that it was a body that we could all accept. I think that that would be a reasonable way to proceed. It is something worth looking at.

**The Chairman:** You do not all have to feel that you need to answer each question.

**Ruth Davidson MSP:** I agree with Lord Forsyth that people need to have reassurance of the process put forward and each side will argue its own case, but there has to be some basis in fact and some evidence to support the arguments of the case. I think that there has been erosion in the trust capital of the current Scottish Government and its ability to present facts. In terms of independent information and advice that is available from Scotland, there is an information service attached to the Scottish Parliament which can present information. How that information is interpreted is not subject to the referee figure that Lord Forsyth talked of. I am not sure whether duplicating the Office for Budget Responsibility in Scotland is the way forward, but I think that there needs to be some way, in what is going to be a very long campaign—two years of claim and counter-claim—in which people can separate the wheat from the chaff, otherwise it all becomes white noise and everyone goes into a state of confusion rather than having information on which they can make the best decision for themselves, their families, the community and future generations.

**Patrick Harvie MSP:** I have no objection to the idea of an independent unit. I have two comments. First, I do not think that there is any such thing as neutral and impartial economics any more than there is neutral and impartial politics. All of it will be subject to interpretation, and perhaps multiple interpretation. Secondly, all parties have now accepted the principle that there should be a referendum and that the people of Scotland have a right to make that choice. It would be harmful to the debate in general—not necessarily to one side or the other—if either side started to demand that their opponents produce a crystal ball to say what would happen in Scotland if people voted one way or the other. No one can give a cast-iron guarantee about what will happen to the economy in either situation. This is about what powers we wish to exercise in a world riddled with doubt and uncertainty, and I would like to be able to make those choices in Scotland.

**Johann Lamont MSP:** Very briefly, I think that Patrick Harvie makes absolutely the right point: you have the information and then, as a human being, you tend to have values and aspirations. The challenge will be, first of all, for politicians to stop closing the debate down and seeing it through our own situation—whether that is anti-Scottish or pro-Scottish, or
whatever. They need to stop framing the debate in those terms. That is really important. There has been a political culture over the past few years that seeks to intimidate over what we seek to debate. It is such an important decision that on all sides we need to open that up. I would make a plea to those beyond the political bubble—the academics, the business people, the trade union people—to start speaking. It is incumbent on those who have a view, one way or another, not to oppose that. There has been a bit of a culture in Scotland over the past few years with people being anxious about speaking out. In the next period, how do we get the expert understanding of what is going to happen in communities if, first, people are to be allowed to speak out and are encouraged about their responsibilities to do so? Otherwise, although we all think we can make a fantastic contribution, it will be very much be along the lines of “He said” and “She said”. This is about pulling the rest of Scotland into this debate, with people having an understanding of and respect for this.

Q592 Lord McFall of Alcluith: At the back of my mind is the question: how do we get an evidence-based referendum? If you are not confident that you will get an evidence-based referendum, given that your parties are cumulatively almost 50% of the representation of the Scottish Parliament, is there a way that you could work together to get that, to bring civic society in and bring in the academics and work to get the economics on board? If we do not have that, we will have the situation mentioned by Professor John Kay, who is on Alex Salmond’s Council of Economic Advisers, and it will take four years of protracted negotiation and concern for people. That will do nobody any good. So can you all work together to get that going?

Johann Lamont MSP: I just say that, as a co-operator, I always like to work together with other people. I think that is right. Across political parties, it is important that people identify the key issues and are seen to debate them. The point I was trying to make is slightly different. Those who are expert in the evidence and understanding need to be encouraged now to bring that to the table.

Lord McFall of Alcluith: Can you have an initiative to establish an umbrella organisation that would include civic society so that we get that evidence base? That is the point I am making here.

Johann Lamont MSP: I am not sure that we need to reinvent the wheel here. I think there are views in the business community, the trade unions, community organisations, and so on. It is about finding the space so that people are able to speak out. We have already had evidence from a range of experts, particularly on the economy, and they have brought their understanding of what the situation will be. I think that this will happen naturally, but the challenge will be, frankly, for the Scottish Government and those in opposition to recognise, as we go through all this, that whatever the immediate concerns are, it must be about more than that. The power of the state is very significant and I just think that there is a need for that to step back so that people feel free to express their views on the constitution.

The Chairman: I have a slightly different challenge in that I have a time constraint on getting this session through. I fully understand and sympathise with the fact that all of you want to speak on every question, but if you are in agreement with somebody else, just say, “I agree”. That would be helpful.

Q593 Lord Forsyth of Drumlean: Perhaps I could direct my question particularly to Mr Harvie. Can you explain to me why anyone would imagine that the Bank of England would want to be lender of last resort to a foreign country, given that the Bank of England does not
have any resources other than what is provided by taxpayers standing behind it and that, if Scotland becomes independent, taxpayers in the rest of the United Kingdom would be asked to act as guarantor to a foreign organisation? Why would that conceivably arise, and what do you think the politics of that would be in the rest of the United Kingdom if it had been broken up?

Patrick Harvie MSP: We cannot really speculate about the politics of that because we would not know the nature of the UK Government at the time.

Lord Forsyth of Drumlean: I am thinking of the voters.

Patrick Harvie MSP: I do not believe that the Scottish National Party, with Alex Salmond as First Minister, should be asserting that this is a scenario which can easily be established. He is right to be focusing on it as a possibility. It is one of the things that would need to be negotiated between the two Governments. It might be something by way of an insurance policy arrangement—a situation where, as part of the negotiation about the finances of independence, this is one of the things that is taken into account. It might be that there are other options that the Scottish National Party Government has not investigated so far: If there is one element of your question that I would agree with, it is that the SNP Government should not be asserting that this can and will happen. I come back to the other point I made before. The negotiation process is not possible until a mandate exists. It is not possible to be clear about either the attitude of the UK Government or the responses of the Scottish Government to its positions until a mandate exists. That is why I think we should be making this decision on the basis of principle rather than on the basis of every promise that we hear from Mr Salmond being a guarantee.

Q594 Lord Hollick: Would you not agree that one consequence of Scotland remaining within the sterling area, if I can call it that, is that there would be a need for Scotland to agree its budget with the United Kingdom? So, far from being free as a bird, there would be a need to sit down with the United Kingdom and agree the budget in some detail, otherwise maintaining sterling would not be possible.

Patrick Harvie MSP: I agree that it is highly likely that a UK Government would find that a necessary position to hold and it would have absolute priority in a negotiation process. That is one of the reasons why I would personally prefer to see any period of continued use of sterling as a transition period leading to something separate. It might be a matter of years or it might be a matter of a generation, but I would prefer to see it in those terms of a slower separation of process rather than a one-off moment of independence. To paraphrase, I would say that independence would be a process rather than an event.

Willie Rennie MSP: You are absolutely right that independence and adopting the pound would give Scotland less freedom rather than more. The terms would be set by the United Kingdom Government, who would be the lender of last resort, and financial controls would be imposed. You might argue that, with the strength of the oil price, Scotland would have a significant weight and it might be more of a negotiation, but I think there would be even more of a requirement for Scotland to live within its means as set down by the United Kingdom, so I think there would be less freedom rather than more.

Q595 Lord McFall of Alcluith: If there was a single pan-UK regulatory authority, would this encourage Scottish firms to become bigger than the Scottish tax base would allow on the implicit assumption that, since they are regulated by the UK, they are the responsibility of the UK? Would there be a perception that any too-big-to-fail institution would soon become an issue for the rest of the UK? I am thinking of Ireland when it gave a blanket
guarantee. At the end of the day, the UK came in with £7 billion to assist Ireland. Do you think that the rest of the UK would find itself in a similar situation as regards Scotland?

Johann Lamont MSP: I would work on the assumption that, if you are getting guarantees from the rest of the United Kingdom, there will be conditions laid on that. There is a conundrum at the heart of this: why would a separate state from which you want to free yourself because you feel that you are not either socially or economically close enough feel any obligation towards you? That is how the language is sometimes couched. Why would that part of the United Kingdom feel any obligation towards you whatsoever? I would have thought that any separate remainder state of the United Kingdom would be very concerned that if it is giving grants and things to Scotland there should be conditions applied. I think that goes to the heart of this issue around financial regulation as well. There is no clarity about how that would work. It flows over into other positions that the SNP has, including what it would do as regards corporation tax. Patrick Harvie says that there would need to be negotiation, but the reality is that the only thing the rest of the United Kingdom would need to negotiate is how we share out debt and any assets. They do not have any residual obligation to go beyond that. There are assumptions made about the obligations on the UK side. This issue is a good example of where the regulatory body would be looking to the consequences for the remainder of the United Kingdom in defining what conditions would be applied to Scotland. If Scotland wanted these other guarantees and protections, it would not be in a position to say that that is not acceptable.

Ruth Davidson MSP: In our very recent history we have had two very big examples of where what we are talking about has come into force: that is, the capital injection and loans that have been required to help RBS and HBOS, the Scottish-headquartered banks that failed. The question I think you were asking was: would a future separate Scotland work on the assumption that the UK’s Government would require the UK to help out? Would there be any requirement on the rest of the UK to give that help? Some £66 billion-worth of capital injections and loans were advanced to recapitalise RBS and HBOS. That is 45% or 46% of Scottish GDP. It is a huge amount. If you are asking me to say what the Scottish share of public sector net debt would be, it takes you well past 100% of GDP. Would a separate Scotland be helped out like those banks? I suggest not. Had Scotland been independent, would the rest of the UK have been under an obligation to help? I suggest not. I think it would be down to the rest of the UK Government whether it wished to help a near neighbour. We have seen that in the past the UK has helped near neighbours—I recognise that that has happened—but I am not sure you can risk the financial stability of a future nation on the good will of a future Government of another foreign nation.

Q596 Lord Levene of Portsoken: You talk about RBS, and clearly that is a big player. What kind of regulatory arrangements would you want to see for large, systemically important institutions that are headquartered in Scotland?

Ruth Davidson MSP: As someone who believes that Scotland should retain its place as a strong member of the UK, I would like to see the future arrangements that are planned in terms of financial regulations put in place. As someone who does not support separation, I am not equipped to state what possible future independent regulation may or may not be best. At the moment, with the stability that we have from being part of the UK, from the strength and size of the UK, from the reputation and the trust capital of being based in the UK, as a country that has always serviced its debts, I cannot see an advantage, or a better regulatory regime that could be built in post-independence than the one that we are currently developing as part of the UK.
Patrick Harvie MSP: Whether Scotland stays part of the UK or not, I can certainly see that there is scope for improving the regulation of financial service organisations, including ensuring that we never again face a situation where we have organisations so big. There is a disease of bigness, which has been part of the problem that has given rise to the culture within those organisations that has caused so much harm. What I would like to see within Scotland, whether that is as part of the UK or as an independent country, is that we move towards a much more diverse ecosystem, if you like, of financial services organisations—small banks, municipal banks, co-operatives—without the market being so utterly dominated by a handful of megabanks. The approach of simply adding one more megabank into the mix is not structural change. I would say that this is about the politics of whichever Government is in charge. Whether they are in the UK or Scotland, they will face the same challenges.

Johann Lamont MSP: It seems to me that it has to go beyond regulation. There has to be a proper recognition of just how reckless and dangerous the decisions that were being made were. To an extent, the First Minister himself was egging on RBS in its purchase of ABN Amro. I am not saying that this is particular to the SNP, but there was a sense that it was not possible that this could not be successful. Indeed, of course, the First Minister said that a problem with the regulatory framework of the UK was that it was gold-plated. I think we all need to step back. I do not think that regulation itself, no matter how heavy it is, is a substitute for people recognising the extent to which we had got into something that was unsustainable. For me, it was a very significant point, the point at which the state had to step in to save the two banks in Scotland. I am not yet quite sure that we have worked through the significance of that in terms of attitude and the way in which the financial sector operated beyond that role. That is something that, on a cross-party basis, we should be having a far more serious discussion about. Regulation on its own, without changing the mindset, is not the problem. It will just lead us to this problem, regardless of what the constitutional arrangements are.

Willie Rennie MSP: Obviously, I am in favour of UK regulation; I am in favour of the United Kingdom. One of the difficulties with this debate is that we get transitory decisions by the SNP Government about what Scotland would look like for the next 300 years. One of the difficulties is that in the heat of the crisis he was condemning UK bank regulation. Now that that has faded slightly, it is now acceptable for him to say that UK bank regulation should apply in an independent Scotland. He cannot have, on the basis of two or three years, such a radical change in position for something that is going to last us for a very long time in the future. It is that kind of transitory nature of this debate: whatever suits the argument at the time applies. We need to get a much more sustainable, long-term view of how we are going to shape this economy.

Ruth Davidson MSP: If I may add just a very brief note further, I think that we should also be listening to the views of the business community and concerns which have been raised, particularly by those in the financial services sector, on the idea of double regulation. If people are operating not only in Scotland but also in the rest of the UK market, there is the hindrance or financial impact to business of having two systems, both down south and up here. Also in terms of the business community, one of the things that costs investment, time and much more is uncertainty. If you have a Finance Minister in Scotland who changes his position as often as the weather changes, what is going to underpin the financial stability and regulatory framework of the nation going forward? That is a really difficult position for people who are committed to focus in Scotland now, in facing this referendum, never mind beyond it. In terms of pressing for answers, I would be very keen to see this Committee, when the Finance Minister appears before you in London, ask him what his position is now in comparison to what it was two months ago and five months ago. People in the real world,
who are not in this room and who will operate the Scottish Parliament, need to know how their business is going to operate in the future and what rules it will operate under. To have that certainty going forward is to everyone’s benefit.

Q597 The Chairman: One issue that will obviously be key in the negotiations, if we get to that stage, is how the assets and liabilities of the United Kingdom should be divided up. On what basis do you think that should be done?

Willie Rennie MSP: This is one of the interesting assertions that the Scottish Government make. They say that we should have a geographical share of the oil revenues and a population share of the bank liabilities. They would pick and choose whatever is of greatest advantage to them, but we need a much more sensible way in which to approach that. There are a variety of different measures that you can look at—spending and population share, a whole range of things. But in general we should be looking at a fair and reasonable settlement, probably based on population share, as that is the best way to proceed. We cannot start making separate rules for different parts of the assets and liabilities, because it takes us into a farcical position, as is shown with the oil.

The Chairman: Is a population basis generally agreed by everyone?

Ruth Davidson MSP: I am not sure that there is general agreement on that. There is agreement in terms of sharing the debt. You can calculate that in many ways, but it could be done by population share or GDP share. They are the two big indicators. There has been some discussion of debt, but there has been very little discussion so far of off-sheet liabilities, which is something that we need to factor into the debate, because those are huge sums. While there has been some small discussion of pensions, we have not really had much discussion of PFI liabilities, which are over many years, or more discrete liabilities, which we have not heard about at all, such as Network Rail debt, and whether there would be a proportion of that. If we are looking at a model for the liabilities that a new separate Scotland divorced from the rest of the UK would have, you have to look at what the position of that nation would be starting out and the liabilities and debt before taking decisions. So there is an incumbency on the people at this table and the people who work in the sector and elsewhere, who have a voice in this debate, to make sure that people really understand the full picture. I do not think that people in Scotland have that yet.

Patrick Harvie MSP: It seems likely to me that both Governments would seek to take a range of attitudes to the basis on which assets, liabilities and debts would be counted. I am certainly not someone who makes passionate speeches at my party conference saying, “It’s Scotland’s oil”, and you would not expect me to, but oil is a geographically specific resource, just as wave and tidal energy will be in future. It would seem odd to say that Scotland would not gain the economic benefit from tidal power in Scottish waters. I suspect that, in the real world, both Governments would try to make their pick of the basis for separating any asset, liability or debt. I would suggest that if both Governments want a fair and honest outcome, some kind of involvement is needed from the international community.

Johann Lamont MSP: I made some points in my paper about the liabilities. To me, this is at the heart of the frustration around this debate. The United Kingdom has through tough times shared resources—human, environmental and economic resources. To me, we do different things at different times; we do not try to find a balance sheet to separate these things off. Geographical happenstance means that oil is in one place and other resources are in another place in the United Kingdom; it is very difficult to unpick the United Kingdom. Those who wish to have independence in Scotland have genuinely said that this is not a
liberation movement, representing a Scotland wanting to leave the United Kingdom, but a parting of friends. That negotiation has to be an honest and genuine one, rather than about who can get the best deal. That is difficult, but it will be a challenge in the coming period. I respect what Patrick Harvie has said. If you are going to unpick something that has worked, there has to be transparency of criteria over how we are going to divide things, not the ones that suit you best in that moment.

Ruth Davidson MSP: I know that you have been talking about oil. Yes, you can talk about the geographical share of oil in the seas of Scotland, but what about future expenditure? We have seen a drop of 60% in production since 1999; there are a lot of rigs that need to be decommissioned. We have already heard from the First Minister that he is unwilling to take on the liability for that future expenditure, even though he wants to have the future receipts from the work that is going on in the same area. As for having a specific example, it has been a case of arguing from a particular advantageous point of view to take on the benefits but not to take on the debts, and I think that there has to be a much more transparent way to move forward. We need to have that set out in a way that is understandable to the general public.

Q598 Lord Tugendhat: A question that we have asked before of other people is whether Scotland would be likely to introduce different rates of corporation and personal tax. Obviously, the whole purpose of independence is that there should be differences, but there would be constraints arising from both the relationship with the UK and membership of the European Union.

Johann Lamont MSP: Let me start off by saying that one example of the SNP’s key messages about the benefits of independence is that it would be able to cut corporation tax. The benefit of that would presumably be to draw business to Scotland but there is a clear risk that competition leads to a race to the bottom and that the folk who would be benefiting would be those businesses that do not want to pay taxation. That is significant enough within a devolved arrangement let alone in an independent Scotland, where this could involve the Bank of England. The last time the First Minister spoke, he said that there would not be a stability pact, but I think we have to work on the assumption that you would need some sort of agreement. I think that they would have quite strong views on Scotland having the ability to do that. I think they have fairly firm inclinations in the case of Europe as well. Should they cut corporation tax, for example, there are issues around how that would be funded and whether you would have a different balance in terms of the spread of income in Scotland.

Ruth Davidson MSP: It will be no surprise to your Lordships that, as someone who would like to see both income tax and corporation tax brought down across Scotland, this is something that I have looked at previously and spoken about at length. First, it is worth remembering that the Scotland Act 2012, which passed through the House of Commons and the House of Lords, devolves a significant level of tax-changing power to the Scottish Parliament without independence. There is the ability to change income tax significantly. That power comes in 2016—two years after a referendum, granted—but without independence so we may well see, even within the United Kingdom context, a difference in income tax levels between Scotland and the rest of the UK.

When it comes to corporation tax, the real argument here is on where work will need to be done going forwards. We are already seeing a reduction in this tax across the UK. The Chancellor of the Exchequer said that he would bring it down to 22% by 2015, I believe, with a view to reducing it to a final figure of 20%, one of the lowest levels in the G7. This
brings us back to the point I made earlier and where we were yesterday as regards the SNP, the current Scottish Government. The argument about is that we do not know whether a future independent Scotland would be able to set its own corporation tax because we do not know the status—

Lord Tugendhat: Sorry, can you say that again?

Ruth Davidson MSP: We do not know whether a separate Scottish nation state would be able to set its own corporation tax because we do not know its status within the European Union. There is an aim within the European Union to harmonise corporate taxation levels. We have already seen an agreement between France and Germany to bring it closer together, which is being used as a template for what I believe is called the fiscal compact for the eurozone nations. There is a level of the hypothetical here, but if a future separate Scotland is an accession state to Europe, it would be forced to take the euro and to go into the fiscal compact, and it would have its corporation tax rate set by Europe.

For me, if we are looking for the rest of the UK to be going down to 20% and at the big drivers within the eurozone, France and Germany, having corporation tax rates of 29% and 32%, there will be a big problem for a separate Scotland in competing with its largest market, the rest of the UK, which would now become its largest competitor. There are a huge number of issues here that need to be looked at. A huge number of scenarios could come out of this. Again, this leads me back to a previous point I made about the uncertainty for businesses currently based in Scotland. There will be hugely damaging uncertainty if we do not have the answers to what is going to happen, post a referendum.

Willie Rennie MSP: There is the legal position and there is pressure from the European Union, particularly on corporation tax rates, on whether Scotland would have the freedom to move in future into doing something on its own. But the SNP is not proposing to turn things around. There is a figure of 12.5% but it is likely to be much larger than that. It is also the question of whether we can afford it. I am not saying that Scotland cannot in the best of times wash its face. It can, in broad terms. This year, the SNP is citing figures that there is 9.6% or 9.3% to Scotland's advantage in its spending and income, but that is taking into account that oil is at a reasonably good price just now. If that fluctuates substantially, the position could alter significantly and impact on the ability of Scotland to vary tax rates. The return that the SNP was citing from this small cut to corporation tax would only be felt over many years. It would be a long time before you got an economic return. You would not have the advantage of being the first to move into that kind of low-tax regime, because others will already be there. There are significant challenges for the SNP in terms of affordability and of whether it would be allowed to do these things.

Patrick Harvie MSP: I would be extremely hostile to the proposal that an independent Scotland should start off with a tax competition on corporation tax. Whether it is in relation to the eurozone, as Ruth Davison mentioned, or simply in closing down those loopholes and opportunities for corporate tax avoidance, the case is far stronger for cross-EU cooperation on corporation tax inside or outside the eurozone. On personal taxes, however, the opportunities really are there to do things differently and to have a more progressive and redistributive approach to personal taxation—or in fact to reduce the level of personal income taxes and replace them with geographically specific taxes, such as a land value tax. That is by no means a new idea; I think that the House of Lords was the first body to discover it. No one who was a Member then, a century ago, is on this Committee, obviously. But the opportunity to do that at a national Scottish level—it could be done at local council level but it would be easier and more administratively simple to levy it at a national level—is
something we cannot do at the moment. It would, again, have benefits in terms of incentivising particular types of economic activity and land usage, which is much more controlled and much more subject to a Government being able to get policy signals than a simple blanket cut in corporation tax, which, as I say, would simply open up the opportunities for corporate tax avoidance—something which I think all of us should regard as morally indefensible.

The Chairman: We have time for two more questions.

Q599 Lord Forsyth of Drumlean: An independent Scotland issuing its own debt would have no track record in the market. Leaving aside all the uncertainties about who the lender of last resort was, and assuming all those issues were resolved, is it not highly likely that Scotland would have to pay more for its borrowing than the rest of the UK, or the United Kingdom as it is at present? Have you made any estimate, given the size of the national debt which, by the end of this Parliament, will be £1.5 trillion? Scotland would have to take its share of that. So a few points difference on borrowing rates is a sizeable amount. Has any estimate been made of the impact of that on the funding of public services such as health, social services and others?

Patrick Harvie MSP: You will probably not be surprised to know that I have not made an assessment of that. I would very much welcome the Scottish Government’s answer to questions such as that. It is the kind of issue which, with their resources, they ought to be addressing. I would encourage you to put the question to them.

Lord Forsyth of Drumlean: And you would believe the answer, would you?

Patrick Harvie MSP: I would take it into account.

Ruth Davidson MSP: I have not done the workings that Lord Forsyth referred to, but he raises a very good point about the ability of a separate Scotland to service its debt and at what cost. We have already had a senior executive from Fitch, one of the big ratings agencies, come out saying that it has never given a AAA credit rating to a new country. I believe that the Chief Secretary to the Treasury, Danny Alexander, and the Treasury Permanent Secretary, Sir Nicholas Macpherson, have suggested to this Committee in previous evidence that whether a new separate Scotland would be able to take on an AAA credit rating could be an issue. While a lot of the work is on the impact on public services, we have had a look on the impact on individuals. The average digression between an AA and a AAA credit rating is 0.77 percentage points. If you look at how that is passed on to consumers, then the answer for Scotland is £850 a year, and there is no guarantee that a separate Scotland would get a AA credit rating. In preparation, I was looking at examples from around the world. The only example that I could find of a new country that is not impoverished, in some turmoil or in some way exceptional, is Montenegro. In 2010, its first 10-year bonds were charged at 7.85%. Compare that with the UK and it is a big difference. What is also worth noting, in terms of the 7.85% cost of a 10-year bond from Montenegro, is that country at that time had a public deficit of only 4.2% of GDP and a foreign debt of only about a quarter of its GDP, which compares favourably with what one would assume a separate Scotland would have. So in terms of the ability to service debt—not only for individuals but for the state—a separate Scotland would indeed encounter some problems.

Willie Rennie MSP: It cannot get any better than the AAA rating that we have in the UK.

The Chairman: That is a very clear and precise answer.
**Lord Hollick:** Whether Scotland is independent or not, it is very dependent on the price of oil, which dominates the Scottish economy. Is there a danger that the oil sector will squeeze out the rest of the economy and draw in most of the investment? Whether it is independent or not, that represents quite a challenge for Scotland. How would you approach that and how would you look at it in terms of how to grow other parts of the economy?

**Patrick Harvie MSP:** Obviously, I would see this in the context of a transition from fossil fuels to renewables. Ruth Davidson mentioned the decline in production. As a Green politician, it is a matter of regret to me that successive UK Governments and this Scottish Government see the priority as squeezing out every last drop that they can. The challenge for the whole world, including fossil fuel-rich countries, is to find ways to make it economically acceptable to leave a good chunk of the stuff where it is. We have many times more reserves of fossil fuels than the world can afford to burn. Scotland is well placed to find ways to do that. We have this vast renewable energy potential on our doorsteps and investment is happening in renewables. It is not down to the Scottish Government’s targets, although it began before that and has been accelerating. We have substantial investment not only in mature renewables such as onshore wind; there is research and development into offshore wind, wave and tidal energy. The challenge for us is how quickly we can do that. How quickly can we scale that up to the extent that we can make it affordable to leave some oil and gas where it is?

**Willie Rennie MSP:** One of the big opportunities for Scotland over the next few years is how it can maximise renewables potential. The question is how to do that. How do we make sure that we use the financial support to make that happen as quickly as possible? One of the big advantages in the UK is that energy consumers throughout the United Kingdom are supporting Scotland in developing its renewables potential. The Institution of Mechanical Engineers did some work on what potentially would be lost from that extra support if Scotland was to be separated. It is in the order of £200 per household by which energy bills would have to go up as a result of separation. We are effectively relying on English, Welsh and Northern Irish consumers to support the development in Scotland. We would be out of potential renewables if we separated.

**Patrick Harvie MSP:** Could I add one further point to that? There is going to have to be a new relationship between the two Governments if Scotland becomes independent, not just because of the existing UK electricity market but also because of the continuously developing European electricity market, which involves cross-subsidy between different jurisdictions. The challenge to do that has to include cross-border arrangements. It already does across Europe and it must if Scotland is separate as well. The Economy, Energy and Tourism Committee at Holyrood down the road, of which I am a member, has just finished an inquiry into renewable energy in Scotland. The bulk of the evidence that we have is that those investors who will be vital to development are not being overly put off by the fact that we are debating the prospect of an independent Scotland in two years’ time.

**Johann Lamont MSP:** I would just make the point that in the current set-up we can have negotiations and can ensure that kind of support. We have these cross-border arrangements. What Patrick is saying is that with independence you have to take that away and then everyone will have to re-establish these cross-border arrangements because they make sense with things such as energy. Increasingly, not so much the Green Party but certainly the SNP has emphasised how little will change, and there is an expectation of the good nature of the neighbours, which we have and we share currently, but we do not know what will happen in the future. It is almost like breaking and refixing something that is
working as it is. On being overly dependent on oil, I think that has an implication for our credit rating and people’s confidence in the economy. I do not think that there is anything inevitable in the view that, because we have a strong oil sector, we cannot then develop other parts of the economy. That is a matter of political will and a matter of political priorities. It is about making sure that you diversify. You make a commitment to renewables. You focus on the important stuff such as growth and jobs for people across our communities. That is where the political divide lies, regardless of the constitutional arrangement for Scotland.

The Chairman: That is a very interesting point to finish on.

Ruth Davidson MSP: May I add one small addendum, Lord MacGregor? The SNP Government publish figures every year quoting the revenue raised in Scotland that is made up of North Sea oil—in 2008-09, it was 21%, by the next year it had fallen to 12%. There really is volatility there. Given that the SNP Government are creating instability within the financial sector, which is another large sector in Scotland, and within the past 18 months have implemented £100 million of new Scotland-only business taxes, I do not think that there is any will from the current Scottish Government to grow or diversify that sector of business in Scotland.

The Chairman: That point about the volatility of oil prices and oil revenue has been made to us by many witnesses not just here but in our hearings in London. You have all done an unusual and pretty impressive thing: you have managed to cover as leaders of four political parties, and dealing with very complex issues, answers within an hour and a quarter. You conveyed clearly to us your general views. I realise that we could have gone into a lot more detail, but we got a very good flavour of your general reactions in this hour and a quarter. I admire that and I am very grateful to you. Thank you very much indeed.
Q725 The Chairman: Good afternoon Mr Tusa. I am sorry we kept you waiting; we had a number of things to discuss. I welcome you to the Economic Affairs Committee. This is the 14th public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. Copies are available in the Room of Members’ entries in the register of interests, and they have declared anything that is relevant. I do not know if you want to make an opening statement or pitch straight into questions but, either way, I ask you to speak loud and clear, both because I do not hear very well and because of the webcast.

Mr Francis Tusa: Fortunately, I have rarely been accused of speaking very quietly, so I hope that will not be a problem. In introduction, I am here partly because I did some of the first analytical work trying to put costs to the whole issue of Scottish independence; this is going back about five years. I originally wrote it for my newsletter Defence Analysis simply because I was short of about three pages of copy and could not work out what on earth I was going to write about. I started looking into the matter and found out that rather than it being a very insignificant affair, the implications were fascinating. No one else had really done any work on it. I have kept that interest going. The newsletter I write, Defence Analysis, is in its 15th
year of publication. It is independent, and does deep analysis on some of these defence affairs: defence, industrial and military.

**Q726 The Chairman:** Thank you. The first question I would like to ask you is whether you can give us a brief overview of the number of servicemen and civilian personnel employed at military bases in Scotland, and your view on the extent to which these facilities provide a significant contribution to the Scottish economy.

**Mr Francis Tusa:** Going to one of the few sources of data from the Ministry of Defence—or partly the Ministry of Defence—in which you can have any confidence in at all, the annual defence statistics, you get a figure for both civilian and military of about—it goes up and down a little bit—20,000 still employed directly in Scotland. Personally, I would doubt anyone who comes up with any figures for indirect employment. I can say only that every time I see a defence bid come in and people try to claim, “Oh, this will employ x directly and 7 million people indirectly”, the figures tend to be so overblown and inconsistent that there is no viable basis for believing indirect employment statistics. But as to the order of 20,000, that is going to be one of the larger employers in Scotland. It is a not-insignificant employer. Bearing in mind the about 6,000—again, it bounces up and down—at Faslane and Coulport, that is a very major employer. If you take into account airbases, some of them have been mothballed prior to Army units probably moving in up at RAF Kinloss and Lossiemouth, and that is not an area that is necessarily abounding with employment. They are going to be very major local employers. It may not be, singly, the largest employer in Scotland but, and this is a scenario that would never occur, if you were to suddenly take all those 20,000 jobs—which excludes industry, by the way, which is a different matter—out of the Scottish economy and throw them away, that would cause a significant degree of hurt, quite frankly.

**The Chairman:** One saw in Germany, when it was a very prosperous country, when we and the Americans started to run down military bases, that although that did not have a big impact on the German economy per se, in the particular places where those bases were it had quite a big impact. The local people were rather upset.

**Mr Francis Tusa:** I remember at the time that certainly the British sector and some of the areas where British bases were closing were not high-employment areas. There were significant problems in finding employment. On the other hand, with the Americans drawing down in southern Germany, they had taken over a lot of property in Munich. Funnily enough, bearing in mind that Munich was quite prosperous, the local authorities were not that worried. They were being given a whole load of really rather well built and maintained real estate. There are going to be swings and roundabouts but, unless someone comes up with a very convincing case that if you were to take the Clyde naval base out and it disappeared, someone else would move in and employ 6,000 people of similar engineering expertise and so forth immediately, that is going to hit the local economy. Just as an aside on this, one of the options that I know has been raised, and I was asked this by the Scottish Affairs Committee, is whether, if an independent Scotland went for its own submarine force of these electric submarines, would that not replace the workforce at Faslane? The answer is no. If you look at the number of submarines you would expect an independent Scotland on the basis of probably defence budgets and so forth to have, it would be equivalent to, say, the Netherlands or Denmark. That size of naval base would probably be about 400 to 500 people, rather than 6,000. There are both benefits and problems with nuclear power. One is that it requires a hell of a lot of manpower—but, then, if you are interested in employment locally, that is not a bad thing.
**Q727 Baroness Kingsmill:** That leads on to the question that I am going to ask you about Trident. You have had some fairly strong opinions, saying that the arguments about it being difficult to move out of Scotland are a red herring, and that it would be jolly easy to move and to store. Perhaps you would like to tell us a little bit about how long it would take, what the implications are and how much it would cost, that kind of thing. It would be really helpful to hear your views.

**Mr Francis Tusa:** Let us for the sake of argument take the imaginary scenario that it all happens in the space of days. You have a referendum that votes in favour of independence, followed very shortly by a general election that the SNP wins and it says, “Our manifesto is that it all goes”. That is the starting position. Any submarine which is not in refit in Faslane could turn on its nuclear reactor and sail to Devonport in the quickest possible time. There are berths at Devonport to house them.

**Baroness Kingsmill:** Deep enough?

**Mr Francis Tusa:** Yes. Remember, all the attack submarines at the moment are based in Devonport. Under current plans they are due to move to Faslane by 2017, but they are based there at the moment. All the Trident submarines are maintained in Devonport, which means that they have to be able to go into the port. It is dredged to allow them to do that. In terms of physically finding a berth which has got nuclear regulations and all those safety things in place, Devonport fits the bill. There is no reason why any of those submarines could not move to Devonport as soon as they could raise steam in their boilers.

As regards the warheads, one thing that is forgotten is that substantial numbers of warheads are kept on a daily basis in Aldermaston and Burghfield because that is where they are maintained. I gather through various sources that there are spare facilities at the moment; they are not being used. You could take some of the warheads stored at the moment in Coulport down to Aldermaston and Burghfield. Inquiries with various people and services since I appeared in front of the House of Commons Scottish committee have indicated that armaments depots at Keinton, and Longtown just across the border, either have or very recently had nuclear certificates. Therefore, if it was a very recent nuclear certificate, recertifying it will not take that long.

None of this is particularly difficult. If I were to come to a main problem, it is the, “Oh, it’s going to take 20 or 30 years. It is incredibly difficult”. It comes down to the Royal Navy being incredibly worried that, if this comes to pass, the Treasury will say, “You, the Royal Navy, will pay for it”. Of course, the previous deterrent—I have a deep memory that Lord Levene had some minor role inside the Ministry of Defence at the time of the Vanguard programme—was paid overwhelmingly from central government expenditure. This time around, the successor programme is overwhelmingly coming out of the core defence budget. My understanding is that the Royal Navy is absolutely, catastrophically scared that if independence comes to pass, it will be thrown a hospital pass and be told, “You must pay for it”. That is why, at the moment, it is keeping its head not just down below the parapet, but many, many fathoms below. If you speak to them and say, “Have you done any planning for this?”, they say, “No, there is no planning”. We heard the Secretary of State yesterday say that there was no planning because it is not going to happen. There is a worrying sense of denial.

**Q728 Baroness Kingsmill:** Would it not be appropriate for them to have at least a plan B? I know that plan Bs are not very popular in this Government, but surely that might be a good idea?
Mr Francis Tusa: I was speaking to a friend of mine who was until recently a Royal Navy officer, one of whose skills is dealing with the teaching and the doctrine of risk, which is now very heavily taught by the Royal Navy partly as a result of embarrassing incidents in planning in the Gulf a few years back. Risk assessment is made up of three things: likelihood, consequence and proximity. Basically, if you run through those, what is the likelihood that there will be an independence vote? Compared to 10 years ago, the likelihood is a lot higher. You cannot just dismiss it as airy-fairy. It is why you are having this hearing; it is why various other Commons committees have had hearings. It is no longer, “Oh, it’s not going to happen, is it?”. So the likelihood is there. The consequence if there was independence for the deterrent patrols and basing is not an inconsequential issue; it is very important. So suddenly that has leapt up the risk register. On proximity, in terms of time we have a pretty good idea of when the referendum will be, we have a very good idea of when the general election will be. The proximity in time of this risk is massive. If this were practically any other army, navy or air force assessment, they would be setting up a risk committee to run through every single aspect of this problem, to make sure that they did not have just plan B, but plan C and plan D. We have to believe that the Ministry of Defence on both the political and military sides have either got the most amazing hidden, cunning plan which will be revealed in the fullness of time, or we have a degree of denial of the order of, “Don’t worry, it won’t happen so let’s just not talk about it”.

Just to give one little example, we heard yesterday the Secretary of State announcing an extra £360 million of forward engineering work on the Successor class of submarines and broader deterrent issues. One of the justifications of this is that to inform a decision after the next election you have to do this work now to make sure that you have an understanding of some of the engineering and higher issues, so that you do not make a bad decision. If you bear in mind that, according to the most recent government estimates, there is £3 billion of investment in infrastructure needed for the next-generation deterrent, if you were to spend the same amount of money proportionately before the next election on infrastructure assessment as they are spending on engineering, you would be spending between £150 million and £200 million. Now, I may have missed something, but I have not noticed anyone announcing a contract for £150 million of assessment in infrastructure, building and facilities. I may have missed it; if I have, I own up.

Q729 Baroness Kingsmill: There was one other element of the risk analysis which you referred to which I wanted to ask you about. Some of the alternative places where there could be these nuclear submarines and warheads are perhaps more densely populated than Faslane, and there is therefore a piece of risk analysis around that kind of issue.

Mr Francis Tusa: True. I have heard people speak about one of the original studies, which saw the ballistic missile boats being moved to Faslane, which was in either 1958 or 1959. I am definitely not a nuclear engineer, but I have a deep suspicion that nuclear engineering has changed more than a little since 1959. The safety cases and so forth are far more sophisticated. Certainly, giving evidence to the Scottish Affairs Committee, afterwards a couple of the members mentioned this idea that Faslane is a risk-free area. They pointed out that the wind comes from the west north-west. If you were to have an incident at Faslane or Coulport with the warheads, the radioactive plume would blow straight over Glasgow. The only people who can believe that it is a risk-free area are people who basically believe that Glaswegians do not matter. I cannot remember, to my shame, the population of greater Glasgow, but something tells me it is in the very high hundreds of thousands, if not the low millions. A bad safety accident at Coulport or Faslane would cause, shall we say, pretty catastrophic problems there.
I come back to the fact that the warheads are at the moment maintained, and some of them are stored, at Burghfield and Aldermaston. The idea that Berkshire is a particularly unpopulated county is possibly not quite true. Again, if you have never been to Plymouth and seen where the nuclear submarines are tied up there, I do not think that the burghers of Plymouth would be particularly happy to believe that an accident in the middle of the dockyard would be a risk-free incident. There are going to be risks, and that is why you run your safety cases. On the safety case line, I would add that one of the areas which I know has been discussed, where there has been a little bit of study, has been whether you could put elements of the deterrent in Milford Haven. After all, it is a very deep harbour. It takes 400,000-ton tankers. People said, “What about the safety case?” If you saw the safety case for liquefied natural gas ships and storage, the idea that it is the equivalent of storing a small Calor gas canister is wrong. It is a horrendous safety case, and I am led to believe that the amount of emergency services to cope with liquefied natural gas coming to the Haven would probably exceed the safety equipment up at Faslane. That was a long answer; I am sorry.

Q730 Lord Forsyth of Drumlean: You mention the Scottish Affairs Committee. I assume that you have read the report, which puts a very different perspective on how easy it would be to move the nuclear deterrent. One of the issues that it highlights is the ability to load the missiles; there are a whole load of technical points. I would be interested in your reaction to it, but in fairness to the Committee’s report, which is very extensive, do you think that you could let us have a note on your views on it, and where you think that it is mistaken. Clearly, you take a diametrically opposed view to the Committee as to how easy it would be to move the deterrent.

Mr Francis Tusa: What is still slightly misunderstood about all this talk about moving the deterrent is that if your starting point is that the Royal Navy and the Ministry of Defence are being told, “You cannot use Faslane and Coulport”, then saying in return, “I’m sorry I want to use them and that is what I have always used” is a pretty feeble position. I come back to one of the original reports, which said, “The best place is Faslane and Coulport for the weapons and submarines”: great, that was in 1959. If in 2014 you get an independence referendum followed by a 2015 SNP electoral victory, it does not matter that Faslane and Coulport are the best bases you could find in the British Isles; you are going to have to move these assets. I have heard senior Royal Navy people saying, “I do not care if they vote for independence, we will keep our submarines there”, which is a slightly strange understanding of democracy. The starting position is that if all this comes to pass, it does not matter how perfect Faslane and Coulport are, you are going to have to move. In which case, coming back to the fact that there are facilities to store warheads in Aldermaston and Burghfield, you could reactivate elements of Keinton. Coming back to the question on the warhead mating, it is a floating jetty.

Q731 Lord Forsyth of Drumlean: Just to cut through this, it would be very helpful to have a note on the detail, but the Scottish Affairs Committee report suggests that it could take 20 years to re-establish the independent deterrent. What are you saying could be done? In what timescale and at what cost?

Mr Francis Tusa: The cost is going to be slightly dependent on where you put things but one of the fallacies is that you find people saying that you would have to replace Coulport, the storage depot. You would not. Coulport is scaled for a Cold War level of deterrent. Back in those days they were even talking about ballistic missile submarines loading, going to sea on patrol, firing their full load of missiles and then coming back and reloading. Now we can sit back and wonder whether that was actually realistic, but that was one of the options.
We have now got the fact that rather than 16 missiles per Trident boat there will be eight. The number of warheads is capped: the number of operational warheads we will be required to have is less than 200. There are facilities for storage in both Aldermaston and Burghfield for all of those warheads. Coming back to the mating of the missiles and the warheads, which is the one part where there is no other existing facility in the rest of Britain, it is a floating dock. So if it was floated into position in Coulport, I have not had anyone give me a reason why it could not be floated to another facility.

**Lord Forsyth of Drumlean**: So what is the answer to my question? How long would it take and how much would it cost?

**Mr Francis Tusa**: Bearing in mind that, from scratch, some of those facilities in Scotland took about seven or eight years, and bearing in mind that you have other facilities elsewhere, first, you can get a deterrent up and running immediately, worked differently from how it is at the moment; and, secondly, to get a more sustainable one would take five to seven years, putting the effort behind it.

**Lord Forsyth of Drumlean**: The cost?

**Mr Francis Tusa**: They have said £2 billion to £3 billion for improvement of infrastructure at the moment, anyway. You could foresee some extra expenditure on moving and putting in the warhead mating facility, but you are not going to see a rise from, say, £3 billion to £6 billion. The key to the whole thing is not to think in the same way. This is being forced on people, and if everyone says, “We did this for the past 40 years in this way”, it is a recipe for failure. There is the opportunity, if this comes to pass with independence, let alone with Successor afterwards, to think differently. I know that some of you around here have business interests. Would any of your businesses take a business plan from 50 years ago as a suitable recipe for how to do business today?

**Q732 Lord Lipsey**: I am a little confused about this cost question because on the one hand you are putting quite low figures, by implication, in what you are saying, but on the other hand you have got the MoD in absolute terror that a huge cost is going to be imposed on it by the Treasury because it will have to pay for this. One or other of these propositions can be true, but hardly both simultaneously. Can you resolve the clash for me?

**Mr Francis Tusa**: Let us go back to one of the original issues, which is the estimate of the cost of the successor deterrent. That has been pitched deliberately high. If you are going to get bad news out, get it out early. It also gives you the opportunity to come in later below estimate and show how wonderful you are because you have managed costs. Even the MoD has just about realised that trying to come in and say that it can do the successor deterrent for £5 billion so do not worry about it, will not happen. In terms of cost, if it has to find even £3 billion or £4 billion, let us say, which it had not budgeted for and had to find out of the core budget, anybody who has been tracking the Ministry of Defence budget knows that there is no room for finding £4 billion of extra expenditure. That is why it would panic.

I come back to this: it is an issue of planning. If, as seems to be the case, no one inside the Ministry of Defence has done any planning for plan B, plan C or plan D, it is coming at this a little cold. It has to be deeply worrying that, faced with any question about this, its only reaction is to bury its head in the sand. The main answer to your question is that it is panicking about it because if it has to find £3 billion to £4 billion in a short space of time, there is simply no room in the budget. Recent Written Answers show that somewhere in the region of 90% of the forward procurement budget is obligated past 2020. In other areas, it is close to 95%. Finding £4 billion is a nightmare.
Q733  Lord Levene of Portsoken: Francis, I listen to what you say. I would never suggest that this could not be done, but from long experience, the cost of doing it and the time taken to do it would be huge. You mentioned that standards have moved on and time has moved on. Standards moving on makes them even tighter, it does not make them easier. It was bad enough doing it at the time when afterwards people said, “Do you realise what you have done, that this and this would have happened?”. Now that will be known up front. You estimated how long it would take to get it through all the planning approvals that you were talking about—a nuclear cloud heading towards Glasgow. You would have all the local interests in the neighbourhood of Devonport up in arms about it. You would have public inquiries. You could end up with a situation where, yes, it could be done, but you would have endless opposition. It would take a lot longer to get that cleared, to get approval to go ahead and then to build it. Then you would have new instructions coming in about what was safe and what was not. I just think that the idea that it is actually quite easy and is not going to cost that much, so just get on with—

Mr Francis Tusa: In more than 20 or 30 years, no one has provided any significant calendar of why they would take it. Bearing in mind—

Lord Levene of Portsoken: I am not saying 20 or 30 years.

Mr Francis Tusa: That is the common figure used.

Lord Levene of Portsoken: If the Royal Navy were forced to move out of Faslane and Coulport in a week, it is not impossible, it could be done, but the time it would then take to get up and running would be huge, by which time you would virtually have lost your capability. There is another option, actually, but it involves a very big political question. If you are just looking at whether we could move the missiles or the submarines somewhere else and run them, yes, we could. We could probably do that in a few months, but that raises a very big political question, which is quite different from the practical, physical question which we are talking about here. So I do not think that it is fair to say that it would not take that long or cost that much. I think it would. It would not be impossible, but the time and cost involved would be unacceptable.

Mr Francis Tusa: Well, if the rump UK still wants a deterrent and Faslane and Coulport are not available, then there is no choice but to bear the cost. I come back to Plymouth objecting and huge committees, planning and so forth. They have a load of nuclear submarines down there anyway. From what I have seen, I do not detect much objection to them. On the contrary, I suspect that you would find great local support for getting the extra work coming in from all those extra jobs. You would, in fact, be moving 6,000 engineering jobs down to the Plymouth and Devonport area. I would suspect that you would probably get a lot more people supporting it.

I would agree that one of the options looked at back in 1959 was Falmouth, which has quite a deep harbour, but I suspect that there are too many lawyers with second homes down there who would object—I apologise to all lawyers here—to the sight of sleek grey submarines mooring alongside their marinas, but if you were to look at Plymouth or somewhere such as Milford Haven, I suggest you would find the local population much more in favour and receptive.

I come back to this. People have just thrown their hands up and said, “It is too difficult”. I am deliberately taking a slightly provocative line, but they could get an up-and-running deterrent not in 20 years, but in the space of months. Bear in mind that one of the boats will be at sea when that is happening, which gives the breathing space. Coming back to the question about planning risk, the whole situation is made worse by the absolute lack of
planning. You talk about costs; the costs would be far worse if there is not a plan B or a plan C so that people would have to make this up as they go along, some time in 2015. If you want a real recipe for disaster, that is it.

Q734 Lord Levene of Portsoken: You say you could have it up and running in months. If Coulport and Faslane were out of bounds, what support facilities would you have in months that would be acceptable from where you could operate?

Mr Francis Tusa: Do you mean alongside the maintenance facility at Devonport, which is fully qualified to take all the Vanguard-class submarines? It is fully nuclear-rated and has all the safety certificates. The one thing that I have always highlighted, the one piece of the puzzle which is unique, is the warhead mating facility, but it is a floating facility and, as a floating facility, you can float it somewhere else.

Lord Levene of Portsoken: There is, as I suggested, another place where you could do it, it is just a question of whether it would be politically acceptable to do it somewhere else. You make some interesting points, but they are contentions that may, or may not, be right. It would be very dangerous just to go ahead and say that if the Government get on with it, it will soon be done. Doing it the first time round created a huge number of problems that we had not envisaged. We got there in the end in a situation where the area in which the submarines were going to be based in Scotland was actually very receptive to it, but if it was now under the control of a Government who did not want to do it, you have a number of very serious issues to confront. I do not think anybody knows what the answer would be.

Mr Francis Tusa: I come back to the fact that if people are not planning now, it will be a nightmare, and it will become an expensive nightmare. You talk about a receptive population. I have not come across any significant signs of opposition from Devonport and that area to the basing of nuclear submarines. I stand by the fact that it is far easier physically to move the boats down to somewhere like Devonport. There are more solutions open. My starting point on this was everyone throwing their hands up in the air saying, “Oh my God, it’s too difficult. It can’t be done”. That is based on a degree of not looking at what the options are.

My starting point on this is, if you have an independence vote and that results in being told “You must move these from Scotland”, waving hands in the air and saying it is too difficult is not an option. You have to do something or you have to accept that the deterrent will lapse. On that basis, I would prefer to see someone spending money, much in the way that the Secretary of State has announced that the Government are spending money to derisk Successor. I would prefer them to be spending millions, if not tens of millions, seriously to look at the options. If that comes out as absolutely impossible, surely that is better. We are better informed all round. At the moment, the Ministry of Defence seems to be flying by the seat of its pants, and if it comes to pass, and all this happens, it is going to be so exposed and the ramifications are going to be pretty horrendous in cost terms.

Q735 Lord Levene of Portsoken: I do not want to prolong the debate but I would just make the point that you are basing your argument on various hypotheses which may or may not be right. It would be very dangerous to stake the future of the deterrent on hypotheses which had not fully been approved. It would take quite a long time to work out whether those could work or not. We are not talking about weeks.

Mr Francis Tusa: Is it not time to start them now?

Lord Levene of Portsoken: That is another question.
Q736 Lord Shipley: Perhaps I may ask you to say a little more about the safety issues. Paragraph 45 of the Scottish Affairs Committee report published last week concludes that, “it would be difficult to find a site that satisfied the requirements for the co-location of the submarine base, the warheads depot and the facility to marry the warheads and missiles on to submarines that adhered to the safety requirements”—I am held to the words “safety requirements”.

Evidence has been given by Paul Ingram, executive director of the British American Security Information Council, who said, “If one were to store the warheads at Aldermaston and Burghfield, which would be a rational thing to do, you would still need to have the loading facilities. You obviously can’t load a submarine at Aldermaston or Burghfield when you would need some temporary storage facilities because you could not do this sort of activity on an off-the-shelf immediate basis. It would not satisfy health and safety procedures”.

Therefore, there is that statement about safety procedures and the House of Commons Select Committee statement about safety requirements. Is what you are saying compatible with those two other statements about safety?

Mr Francis Tusa: Yes, they are. They are just coming from different sides. The warhead mating facility is a floating facility and was floated into place. Could it be moved to somewhere else? Yes, it could because it is floating. So that safety issue can be moved elsewhere.

Coming back to the basic point, if we are talking about independence of Scotland and it asks for all these things to be moved, would any solution you could come up with be as convenient as what there is today in Coulport and Faslane? No they would not. Coulport and Faslane is beautifully convenient and there are no obvious areas that will be as convenient. It comes back to my point that people will have to do things differently.

Can you foresee a situation in which one of the Trident boats comes back from the United States having loaded on missiles in Kings Bay, Georgia, and someone drives up with a transit van with a couple of nukes, you just put them on and it sails away? The answer is no, probably not.

One piece of infrastructure that people will have to look to start building pretty quickly is, whatever you want to call it, an interim or intermediate warhead storage facility wherever you are going to base the warhead mating facility itself.

However, to come back to the point about Coulport, people say that replacing Coulport would cost too much. You do not have to replace Coulport because it is scaled for hundreds and hundreds of nuclear warheads for a Cold War level of deterrent. We have announced that we are going to have fewer than 200. Therefore, with the scale and number of warheads going on board one of the submarines—eight missiles with about four or five warheads each—you are not having basically to carve huge bunkers into a massive piece of Scottish granite. You are talking about a much smaller facility.

You would not have to spend the same as it cost to create Coulport in the first place because you are talking about a far smaller piece of real estate.

Q737 Lord Shipley: You have raised the possibility of storing the UK’s nuclear weapons outside the UK, for example, in the French facilities off Brest. How feasible is that? Would it be more or less expensive than finding somewhere to store the warheads in the rest of the UK?
Mr Francis Tusa: I suspect that in the medium term a UK solution will always be more satisfactory. The French solution was raised by some French people I spoke to and the suggestion is that that would be far more achievable, say, than doing it from a US side, which would cost considerably more. The distance is also an issue.

Is it ideal? I do not think that any of the overseas storage options are ideal. But I come back to a basic point: if the UK is stuck with the fact that its ideal solution based at Coulport and Faslane is no longer available, you have to look at all the options. Bearing in mind that we have now come to an agreement where we are willing to share nuclear testing and nuclear trialling facilities with France, you may wish to examine that as an option. Funnily enough, the biggest sticking point would be whether the US would be happy with us taking weapons over there. Likewise, as regards taking stuff over to the States, I am not sure that that would be equally likely. However, again, these things have to be looked at properly.

Coming back to the basic question, if no one is looking at these and, come 2015, the issue of independence and having to move the deterrent comes to pass, if no one has gone through all this studying, they will be in a world of hurt.

Q738 Lord Rowe-Beddoe: I should have declared the interest that both Mr Tusa’s parents are family friends. Let us get away from the discussion of location and so on and take the scenario that Scotland has voted for independence. From your knowledge and the work that you have done in Scotland, do you think that, politically, it is viable that the Scottish Government may be prepared to accept the continuance of the base at Coulport and Faslane in negotiation for other conditions, such as better financial arrangements or other quid pro quo?

Mr Francis Tusa: On the issue of treaty port status and so forth, Faslane was raised seriously around six or seven months ago for the first time. Just listening to the comments after the SNP’s annual conference where all its key Ministers seemed to rule that out absolutely, there was also talk about the fact that an independent Scotland would, if I remember rightly, vote to make possession of nuclear weapons on Scottish soil illegal, and so forth. If that is a negotiating position, it seems a rather strange maximalist one that rules everything out before you even get to the negotiating table.

My understanding of what I saw on the commentaries on the SNP’s recent conference was almost that, in return for a vote in favour of joining NATO, it had gone slightly even more hard line on the nuclear issue; thus seeming to rule out any negotiation.

I would be slightly surprised, almost verging on horrified, if anyone were to accept the treaty port status concept. It seems to be a wonderful hostage to fortune that someone can say, “Yes, I’ll sign a treaty port status”. Two years later a Government in Scotland could say, “We’re a bit short of money. We’ve decided that there is now a nuclear levy for moving nuclear warheads”, or “We have to impose a new fee”. There would be permanent problems about using that if you have the situation you have described of the fully independent Scotland desirous of getting all nuclear weapons out.

Quite frankly, even though it might be more trouble in the short term, if you are faced with that, clearing all the nuclear submarines out to a different base, starting from scratch, will probably be a better solution than a 50/50.

Q739 Lord Rowe-Beddoe: May I have one supplementary here? I am increasingly confused with regard to the forecast of employment connected with Faslane.
There was an FOI to the ministry last week, which I am sure you have seen, suggesting that 520 civilian jobs are reliant on Trident. Of course, that has now been used by the SNP to pooh-pooh these figures of 6,000 and 11,000. Can you help me?

*Mr Francis Tusa*: The FOI figures do not include the Royal Navy just manning submarines. Quite frankly, if the entire workforce manning the submarines at Faslane when they go on patrol is 159, it is pretty amazing. So the figures exclude all those crews. The Secretary of State said in Faslane yesterday that the number of people employed there would go up from 6,000 to 8,000. That is because, in theory, if there is not an independent Scotland, all the nuclear submarines are meant to move to Faslane by 2017. The entire workforce today in Devonport would move up to Faslane, the Clyde naval base. There are ancillary facilities in the Clyde naval base. On employment directly relying on Trident, I suspect that the Ministry of Defence—typical MoD—rather than giving a simple answer, has given a very legalistic, limited one and taken Trident almost to mean the missiles and the fire control system rather than things like the reactors, the sonar and so forth. That would explain the difference. My life is made up of putting FOI requests to the MoD and getting back the weirdest answers, whereas it would save it so much time if it actually gave the right information out in the first place.

**Q740 Lord Rowe-Beddoe:** But crews will be crews wherever they are; they are not necessarily jobs in Scotland. If you move everybody, you cannot count that, can you?

*Mr Francis Tusa*: You would then have the accommodation to put them in and the people running the accommodation. Among the plans that you would have to make if you were moving the rest of the nuclear hunter-killer submarines up there would be expanding the amount of accommodation in and around Clyde naval base. So there are all those extra jobs. They may not be quite as prestigious as nuclear engineers, but these are the type of jobs that make up your 6,000 figure. It is people in uniform physically operating the submarines; training; doctrine; you name it.

**Q741 Lord Hollick:** I wonder if we might move on from Trident for a moment. If Scotland votes for independence, how would you seek to divide the assets and liabilities in defence? Would there have to be a transition period? You referred earlier to an independent Scotland having a defence budget akin to that of Denmark. Perhaps you could just flesh that out and tell us what you think would be the cost to Scotland of running an independent defence facility?

*Mr Francis Tusa*: These two things are connected generally. Let us deal with the defence side and the budgets first. In the past, you have certainly heard the SNP talk about having defence comparable with the arc of prosperity, so Denmark, Norway, Iceland, Ireland and countries like that. You can then look at the proportion of GDP spent on defence by those countries. The average is about 1.27% of GDP. It is then a question of working out exactly what you believe Scottish GDP will be. On all the occasions that I have run an analysis on this, I have always added 50% to every single estimate of Scottish GDP so as to overestimate it and not be accused of deliberately underdoing it. You end up with Scottish defence budgets on a high estimate of about £2.7 billion and, on a low estimate, of £1.75 billion. You can then take those figures through on both British and continental figures for spending on procurement and you get a high figure of an independent Scotland spending about £0.5 billion on procurement or a low figure of about £225 million. One of the reasons why there is a general range of figures is that the SNP quite rightly says that it cannot state exactly what it would spend until Scotland was independent, but you can certainly provide a range of figures and then start looking at what that would buy. If you are ending up somewhere in the
middle and a defence budget of around £2 billion for everything—manpower, bases, procurement and so forth—would you be looking at a Scotland having, or even mirroring, the same range of capabilities as today? No. It is just not possible to do it on the sums. I repeat that, every time I have done an analysis on this, I have added 50% to estimates for GDP. You have a pot of equipment in the British Armed Forces today, for all three services. People say, “Oh, it'll be horrendously difficult to work out who gets what”. Well, why not sit down and try? The ways in which you can do it are by looking at tax take—what proportion of tax take do you reckon an independent Scotland has provided to the general pot—and the proportion of Scottish GDP to the general. You then sit down and just work out it very crudely. If Scotland has given 10% of the tax take, then, on that basis, it would be entitled to 10% of the kit. Now, you can go through that and end up, absolutely naturally, with some things that look absurd. For example, out of a fleet of eight hunter-killer submarines, Scotland is basically entitled to 0.8% of a submarine. That is absolutely ridiculous and stupid, but you then get down to horse-trading, which is of course what will happen. You have a Scotland that says that it does not want nuclear anything, so it would then be in a position where it would basically look to trade assets that it did not want for ones that it did. People say that it would take 20 or 30 years to do this. Why? I am going to misquote Macbeth now, and I was thinking of this on the Tube on the way here: if it were done best, it would be done quickly. If you are going to do this, rather than saying that we will have a 30-year divorce and just take years to do it, why not sit down and work it out? Let us bear in mind that when Czechoslovakia split it managed to do this in a couple of years, albeit with a much smaller armed forces, but it would have run across exactly the same problem: “Who owns these tanks? Who owns these surface-to-air missiles? Who owns these aircraft?” If you sit down and work it out on the basis of GDP, tax take and things like that, I think that you can come up with some pretty reasonable solutions pretty quickly. It would not take 20 years. Will there be transition period? Yes. Are there issues to consider? One of the first things that you would have to do is ask all the members of the Armed Forces, “Do you wish to have a British passport or a Scottish passport? Do you cleave to one side of this?”

**The Chairman:** Quite a lot of people in the British Armed Forces have other passports, do they not?

*Mr Francis Tusa:* Yes. But ask the question and see who wishes to be regarded as Scottish and sees their home as being in a Scottish defence force. That would give you a very good starting position as to how many men and women wish to go either way. There is a potentially unpleasant truth to be discovered in asking whether a member of the Armed Forces wanted a Scottish passport or a British passport. I have a pretty good suspicion that, when faced with joining a Scottish defence force that, on the basis of what we know from SNP policy to date, would be involved in the odd UN operation and that is about it, or joining Armed Forces that were actually going to deployed on operations, an awful lot of people in Scottish regiments today or in Scottish-affiliated units, ships and so forth would prefer to join the British Army and not go for the Scottish armed forces.

**Q742 Lord Hollick:** Let us take your own, admittedly crude—your own words—reverse engineering and say that you have got £2 billion to spend. You have taken Faslane out of the equation. Clearly, it would be absurd to cut other armaments in half. But talking about the number of military personnel on the ground, do you have any views as to how that particular debate might end up? Would it lead to people coming south of the border or moving north of the border? How does that work out?

*Mr Francis Tusa:* You are going to see a far smaller Scottish footprint. Or, although I have not seen these in recent SNP party documents or manifestos, in the past it has said that it...
would restore all the regiments disbanded and keep and support all the bases. Once you say that, the current cost of operating, excluding aircraft maintenance and flying for Lossiemouth, Kinross, Leuchars—and I exclude Faslane, largely, and Rosyth—it is the better part of £1 billion a year. If you have a £2 billion defence budget, and you have just spent £1 billion of that on literally operating bases, you will not be left much money for anything else. On the manpower side as well, if you are saying that we are going to restore all these battalions—and there are some very helpful parliamentary Written Answers from the past three years on the cost of recruiting and sustaining a battalion; it is about £25 million a year for an infantry battalion, give or take—you can start doing some very easy and robust reverse engineering of the costs. With a £2 billion defence budget, if you are defending bases and regimental titles, you will have very little money left for equipment or operations, and it will not go anywhere really. People will come south and kit will come south.

Lord Hollick: So without putting words into your mouth, although you have probably given the answer to my question, this would lead to a smaller number of people involved as military personnel.

Mr Francis Tusa: Yes, and this is even before you consider the defence industry, where the implications are even worse.

Q743 Lord Hollick: Sticking on that thought, has there been any discussion about the location of the defence industry?

Mr Francis Tusa: No, and it is one that you will never get anyone from the defence industry to discuss openly, for fear of being seen to be political. Industry goes where the money is, and if you have a like-for-like Scottish defence procurement budget of somewhere, depending on the range of estimates, between £300 million and £500 million, and the equivalent British defence budget of £6 billion, or close to £7 billion, where do you site your factories? The biggest and perhaps the most important defence employer in Scotland—or one of them certainly, in terms of technology—is Selex, which produces the radars for the Typhoon. As with a lot of the other electronics firms, although you will not get any of them to say this publicly, if you had an independent Scotland with a much lower defence budget they would move their facilities down to Milton Keynes, to their other factories, because that is where the money is, pure and simple. It is also because they fear an industrial threat from Thales, which is trying to break their monopoly on Typhoon. So it is good, old-fashioned industrial warfare.

Q744 Lord Hollick: Have you been able to assess the loss of money as a result of that migration south of the border?

Mr Francis Tusa: You have to work this on rough figures, unfortunately. Let us assume, on independence and so forth, that Selex says, “Right, that’s it, we’re out of here”, bearing in mind that that firm gets somewhere in the region of 24% and 29% of the value of every Typhoon, which cost £60 million each, that money, in revenue going into factories just outside Edinburgh would disappear. I believe that the last data that I saw on the engineering side talked about people on a good, £35,000 plus salary basic, and probably 2,000 plus engineers moving. It is a not insignificant issue to consider.

Q745 Lord Lipsey: If I could move us from the Scottish defence budget to the impact of the defence budget of the rest of the United Kingdom, you explained earlier what a terrible blow it would be and the hole that might come to the Ministry of Defence from removing the nuclear deterrent. You can tell me if I am getting the steps right here. The defence mission for the rest of the United Kingdom will not be appreciably different than what it is
today as a result of Scotland going, but there will be a revenue loss of £3 billion, which is the equivalent of the Scottish share, give or take, of the total UK defence budget. Is that not another £3 billion hole in the MoD’s budget? It would either have to get the Treasury to give it the money or it would have to find the cuts.

Mr Francis Tusa: If you are going to try and find success out of loss or defeat, you can look at the fact that you would probably be transferring somewhere in the region of 20,000 people of various grades, civilian and military, to the Scottish defence budget, which would save you a certain amount of money. If you then look at how you can do things differently in terms of supporting some of the operational side, so that you can mitigate the impact of those jobs being moved, there is still quite a lot of fat to be cut in the MoD and you would not be faced with a £3 billion black hole. The area where you would probably have more concerns is more on how you would divide staff with a direct £3 billion. With an assumed loss in terms of procurement spending of around £0.25 billion, given how squeezed the procurement budget is at the moment, that is going to be bad. Coming back to the point about defence missions, and so forth, if you go back to the issue of sharing out the kit, Scotland is entitled to 10% or 12.5% of all things at present in the British Armed Forces. As one example, that will mean two or three escort ships are given to Scotland. There are officially roles inside the UK defence mission for all those 13 frigates and six Type-45s. On that basis, if you want to stick to the current defence missions, you would have to replace them. I would not want to seem overly cynical, but something tells me that whoever was in power at that time would tell the chiefs of the Army, Navy and Air Force to go away and come up with a different way in which to justify doing the same mission with less equipment. By that stage, trying to construct a new type-45 destroyer, for the sake of argument, will not be an option. So in theory the rump UK would be short of some bits of equipment, most notably in the naval sphere. If the UK were to lose 24 Tornados, would it matter? No. If it were to lose 18 Typhoons, would it matter? No, not really. Losing two escorts would be a pretty significant hit, and it would be an area where someone would really have to consider whether you could manage with 11 frigates or whether you would have to go and buy two more. I would love to think that a Treasury of any sort would say, “I understand your pain, here’s the money”. But I think I know what the answer is.

Q746 Lord Lipsey: It is almost worse than you are saying. You are talking about the fat that is there at the moment and what we are going to go through before any of this comes about. There will be four or five more years of extreme fiscal restraint, which will mean the MoD, kicking and screaming, losing a good deal of that fat as well as possibly some meat as well. You are really talking about a budget that is relatively smaller than it is today, and you are suddenly going to give it two hits—some £3 billion for Trident, possibly, and another £3 billion for the loss of the Scottish share of revenue. This is very tough indeed, is it not?

Mr Francis Tusa: I would repeat one thing, coming back to Trident. The military is not making its case that this is not something that can be readily shouldered by the core defence budget. I have no evidence and no one has heard of any significant representations about this, and if they are happening they are happening so quietly that the waves that need to be made are not being made. It comes down to whether one believes that a Treasury—and I would leave it to others around here with far more experience of the Treasury—would listen to entreaties for extra money from a department that is unfortunately categorised as being incredibly wasteful and be willing to put its hand into the reserve to find the money. I would have thought that one of the few mitigating things that the MoD might try, bearing in mind the confluence of dates, is to say, “Look, we’re getting out of Afghanistan early. You’ve been stumping up £3.5 or £4 billion a year for that, so how about we come to a deal
whereby you are not giving that money for Afghanistan but you give us £1.5 billion to mitigate these types of cost”. But I leave it to others to say whether the Treasury would entertain that for more than five minutes.

**Lord Lawson of Blaby:** The Treasury is always very understanding.

**Q747 Lord McFall of Alcluith:** The SNP in Scotland has consistently said that Faslane is no problem because it will just keep it open: it will be business as usual. What is your view of what Faslane will be like? Given what you said that it was without considering the implications for the defence industry in the rest of Scotland, what will it look like on the Clydeside, in Rosyth, Edinburgh and elsewhere? What will that do for the skills infrastructure in defence?

**Mr Francis Tusa:** Funnily enough, that will be heavily dependent on the size of the Scottish budget. I certainly subscribe to the view that Scotland, if it takes the oil side and economic exclusion zones seriously, would not want to have its only naval base at Faslane. Funnily enough, every time you went on a mission you would have to do a 600-mile journey to get on to station. In the case of an independent Scotland, you would have to keep something—Rosyth is the obvious example—open on the east coast to deal with that. In which case, and looking at the likely size based on GDP defence budgets, you are looking at a Scottish navy of four to six patrol vessels and three to four frigates, maximum. The question is then whether Scotland goes for conventional submarines. It was mentioned earlier that, were Faslane to be converted from its current format into a conventional submarine base, on the likely comparisons with the Netherlands, Denmark and so forth, that base would employ about 400 people, excluding crews. The crew of a conventional submarine at the moment is about 35 to 45 people. We are talking about a substantial reduction. You would be looking at two naval bases with approximate garrisons and running staffs of 400 to 500 on each coast—a lot less than the current jobs based at Faslane as it is today, let alone the proposed Faslane after you have moved all the nuclear submarines into position.

**Lord McFall of Alcluith:** So you are saying that the strategic interests of Scotland are not best served by having a base on the west coast?

**Mr Francis Tusa:** It would seem strange if one of the issues of an independent Scotland was not the importance of oil. I know that people are looking further out into the North Atlantic shelf and so forth but a lot of the facilities are still in the North Sea. It would seem strange and I do not think it would be necessarily cost effective if all your ships were just based on the west coast and so for about half their missions had to do a 600-mile transit every time they left. You could say that it is for that reason that the rump UK has kept a number of naval bases and facilities open at extra cost to mitigate for circumstances such as this.

**Q748 Lord McFall of Alcluith:** How significant is the SNP’s decision to apply for NATO membership, as it undertook at the conference, in terms of affecting Scotland’s defence expenditure and the negotiations that they will have to engage in with NATO? What are your thoughts on that?

**Mr Francis Tusa:** In theory—I put that with a degree of cynicism—if you are a NATO member, you sign up to theoretical commitments on levels of defence expenditure. The fact that those are broken by quite a few countries perhaps means that everyone can get away with it, but you sign up to a degree to standards and concepts that mean that some decisions—especially on procurement and so forth, the interoperability and communications—would not per se be yours, much as the UK cannot run a totally independent policy on communications. If you are to be NATO interoperable, you must
meet certain standards. The previous policy of no NATO, no nuclear, no nothing was illogical. You can see that in the fact that at the conference they voted to join NATO even though there was a very strong strand inside the SNP that did not want that to happen. But a Scotland trying to stay resolutely outside NATO would be a nonsense, especially bearing in mind the whole of the North Sea, the movement of defence towards the polar regions and so forth. The single biggest defence issue that would affect an independent Scotland in the next 10 years is the polar regions. It does not take rocket scientists to work that out. Just look at the defence policies of Norway, Denmark and Canada as three examples. They are all focused that way. If Scotland just sat in the middle of that jigsaw going, “Not us, mate”, it would be a bit of a nonsense.

Q749 Lord McFall of Alcluith: Within NATO, apart from the fact that we might be welcomed or not, do you see Scotland being hermetically sealed from the nuclear side or, by dint of membership, being involved in the nuclear strategic framework?

Mr Francis Tusa: You could say that as soon as you join NATO you accept that you are under a nuclear umbrella. But then, could you foresee even an independent Scotland that was not a member of NATO not indirectly falling under that nuclear umbrella anyway? It is perhaps a little more obvious if you are in NATO that that umbrella is in place. I am not going to get into arguments on whether that means there is a degree of shutting people’s eyes to unpleasant truths. If you are in NATO, the guarantor of NATO is the United States. The United States is a nuclear power and Article 5—an attack on one is an attack on all—means that you accept a degree of nuclear safety.

Q750 Lord Forsyth of Drumlean: Perhaps I do not know enough about this to understand it but how can you be a member of a nuclear alliance while maintaining a policy that no ships with nuclear weapons can come into your coastal waters or dock in your ports?

Mr Francis Tusa: It will be interesting but Scotland could point out that that is not a problem with Danish or Norwegian ships. Also, even though relationships with New Zealand were suspended when it had its policy of not allowing American nuclear vessels specifically into its ports, I did not notice New Zealand being kicked out of the five-power alliance. There may have been incredibly strained relationships—there were. Eventually New Zealand gave up and said, “Okay, we will allow them in. It was not that you must say, definitively, that you do not have weapons on your ships”. You can work around that but, as I said, I think that if you join NATO you accept the nuclear umbrella and that safety guarantee.

Q751 Lord Forsyth of Drumlean: You are saying that with precedents that it would not be an issue for people accepting an independent Scotland as a member of NATO that it had just kicked out Trident and created all this disruption?

Mr Francis Tusa: Let us put that with the issue of the EU, where it turns out that perhaps people have not taken the advice of lawyers on whether they get grandson rights. This may well be an issue with NATO. There is not automatic joining of NATO. Scotland cannot just inherit membership. Whether it will have to renegotiate aspects of that is probably now an open question.

Lord Forsyth of Drumlean: Sorry to press on this and I realise that it is perhaps a bit of a political question, but it seems that you have a slightly different view from the Scottish Affairs Committee as to the impact but you are both agreed that it would be highly disruptive and it is a matter of the degree of extent. An independent Scotland takes this line and then says, “We would like to join your organisation”. Is it conceivable that people would
say, “Well, actually we would quite like to maintain our presence at Coulport”? It might not just be an automatic process.

Mr Francis Tusa: If you have a newly elected Government with a manifesto that says, “We are shifting everything out”, and a demand for joining NATO says, “You must allow nuclear weapons to be based in Scotland”, then they are not going to join NATO.

Q752 Lord McFall of Alcluith: Would NATO accept Scotland’s application with equanimity, or do you see any problems?

Mr Francis Tusa: Perhaps the drive for expansion of NATO post the fall of the Berlin Wall meant that people in those early stages were willing just to accept countries in almost willy-nilly. I think we have seen a slowdown on the acceptance rate. In the aftermath of the recent issue on the European Union and whether Scotland would inherit a place in the EU, I suspect that the same lawyers who assessed Scotland’s position in the EU should probably look at NATO. That particular case has called into doubt whether Scotland would just inherit a successor position in NATO.

Lord Hollick: On the same topic. George Robertson, who when he was Secretary-General of NATO negotiated the admission of seven new countries, wrote in a recent article that, “not one of them laid down conditions” for joining, and that, “Not one of them dreamed of contradicting the alliance’s strategic concept—that declaration of the purpose agreed every 10 years. None of them rejected the nuclear umbrella”. He made the point that it is rather like, “applying to join a golf club with the objective of preventing golf being played”. He seemed to be saying that it is inconceivable that Scotland could be admitted to NATO with the preconditions that it has set down.

Mr Francis Tusa: In which case, it will be a very interesting negotiating time. You may find that some members of the SNP who do not want to join NATO in the first place have their wishes granted.

Lord Levene of Portsoken: Francis, I find some of your statements very odd. You say if Scotland has the choice—“either join NATO and accept you are part of a nuclear alliance or do not join NATO”—it will not join NATO. How do you know that that is what a future Scottish Government would do?

Mr Francis Tusa: I do not at all.

Lord Levene of Portsoken: You said it as a statement of fact. You said, “Then they will not join”. How do you know that?

Mr Francis Tusa: Given a straight choice of, “You must accept the nuclear side”, as we have just heard with the statement there, if it is a straight choice of A or B, as that article by George Robertson makes clear, it is going to be rather difficult for Scotland to join NATO, is it not?

Lord Levene of Portsoken: That is true. It may be quite difficult for it. But I do not think you should sit there and say, “In that case it would not join”. The new Scottish Government can say that. It is not right for you to say that as a statement of fact.

Mr Francis Tusa: Fine. I should not be asked the questions that ask me to state that thing, quite frankly.

Q753 Lord Levene of Portsoken: You chose to give the answer. Can you think of any examples of countries that gained independence or split from the political structure they
were in before where there is a precedent for handling the division of defence assets and liabilities that could be used as an example if Scotland were to become independent?

**Mr Francis Tusa:** There are two, one more applicable to the issue of nationality, and residual issues of the British Armed Forces, and one for equipment but also nationality. The first example, on the issue of an independent Scotland asking soldiers, sailors and airmen which armed forces they want to join, you can look back at Irish independence, where a similar process took place. One issue that is very relevant is that today we still recruit for the British Armed Forces in the Republic of Ireland and a treaty is in place to allow people from the Republic of Ireland to serve in Her Majesty’s Armed Forces. This was worked out relatively easily. I see no particular reason why you could not take that draft from Irish independence and literally change the words “Ireland” and “Irish” to “Scotland” and “Scottish”. It has been accepted as a valid legal document, so that is one area where that happened. That example is not necessarily as relevant for equipment simply because the amount and types of equipment at the time were much smaller and less complex. In terms of the more complex one, there was the velvet divorce of the Czech Republic and Slovakia, where there was no navy, of course, but air forces and land forces. The ability of the two sides to sit down and work out exactly who was going to get what produced remarkably few problems—perhaps because it was a relatively small amount.

**Lord Levene of Portsoken:** They did not have an awful lot to divide, did they?

**Mr Francis Tusa:** They had more main battle tanks than we did at the time, as just one example, and certainly more surface-to-air missiles. But people have done this. There are only a few examples, but the starting point for any of this analysis is if Scottish independence comes to pass and there is a divorce, you are going to have to sit down and work out how to do this. If you were in the Ministry of Defence you would want to be putting your plans in place now about the ways you would choose to do this. At the end of the day if people end up just having rows—“I demand you give me this”. “No, I won’t give you that, I will only give you the following”—it will end up in the international court of settlements in Switzerland and it will be sorted out there, at great cost. It would be far better if people sat down and, on the basis of tax take, GDP, all of these things, get a starting position from which you can then negotiate: “I will negotiate you eight Challengers if you give me one frigate”—that type of thing. Does it look particularly messy? Yes, it is going to be slightly messy.

**The Chairman:** On Ireland, am I not right in thinking that the way in which the army was done was that some regiments came to the British Army and other regiments were disbanded so things like the Connaught Rangers and the Royal Irish Rifles and so forth disappeared. Therefore, the precedent is that regiments would either remain with the British Army or they would disband and the Scots would start again.

**Mr Francis Tusa:** Or the other way round, but you would suspect that a Scots Guards will probably exist after a separation, if only because we still have an Irish Guards, and that was some time ago. Either of those solutions—one side disbanding and reforming, or the other way round—has been done before. It worked. It provides a seemingly quite reasonable blueprint and it has a legal backing that no one has queried as needing to be updated. That side seems to work very nicely. There are a number of ways you can work the kit side out. Will there be squabbles? Absolutely, and there are two or three little gin traps I can see people walking into, but it is certainly something you can do. People are talking about taking 20 or 30 years to achieve it. I would want to see very detailed timings of why it would take 30 years. My initial one took me less than two days. People can say they disagree with this or that, but until they come up with a better way of doing it, I would stand by it.
The Chairman: Did anyone have any further questions?

Q754 Lord Forsyth of Drumlean: I am intrigued by the prospect of the Scots Guards ending up not being part of the Scottish army. Going back over the ground about the nuclear deterrent, you set out that, because of force majeure, we would have to look at a different way of doing things. You made the point that the number of warheads at Coulport and the scale of the thing all related to a different world. I find myself sitting here thinking whether this whole debate about independence is likely to precipitate people thinking about providing our independent deterrent in a different way. Lord Levene will get cross because I am asking you to speculate but could we end up in a position where we—the people in Scotland—lose what we have at Coulport and Faslane because of the uncertainly that has been created and the need to find economies? Is that a practical possibility or is the set-up there just so brilliant, well conceived and co-ordinated that no one would want to disturb it unless it was through some vote to fracture the United Kingdom?

Mr Francis Tusa: I think it is the latter. All the comments from the Navy are about the total lack of contingency planning, and you heard the comments from the Secretary of State yesterday that there is no need to have contingency plans as it is not going to happen. There will be 8,000 jobs at Faslane, because that is what the plans are. We come back to the fact that Faslane and Coulport are probably, almost without doubt, the best places in the British Isles to do what they are doing in terms of the deterrent. But what happens if there is an independent Scotland?

Lord Forsyth of Drumlean: There is one half of the coalition who I gather are busily working away to try to find some sort of low-cost alternative. They can look, but are we on solid ground if we assume that the present set-up is the right one and there is no alternative unless one is forced to find an alternative?

Mr Francis Tusa: Yes. The one thing that I would say is that there probably should be, simply because it is 30-plus years since the previous deterrent. Disastrous may be too strong an expression, but if people cannot find new and better ways to provide the same deterrence, bearing in mind advances in engineering, and if we just built the same submarines with the same reactors and technology and said we will do everything the same way as we did in the early 1990s, that would be a missed opportunity.

Q755 Lord Forsyth of Drumlean: Given that we are dependent on the Americans for Trident anyway, what is the downside of using an American base in order to provide the facilities that would otherwise have been provided in Scotland?

Mr Francis Tusa: Distance, as well as whether the Americans will let us have facilities and how much they will charge us. The idea that the Americans say that we are their best mates and let us have those facilities for free simply does not happen. You would have to be very careful. More broadly, in terms of a successor, we are already in a situation where the UK is funding the common missile room, the next building block for the submarine. The Americans have slipped their programme by six years and we are already facing a situation where, if we are to get a successor going ahead on time, we will have to fund the entire programme, but the Americans do all the work. That could be a significant point of tension and even failure for the successor class of submarines. Relying on the Americans is difficult and fraught with danger.

Q756 Lord Lawson of Blaby: I agree with you that the lack of contingency planning—or even contingency thinking, it would appear—in the Ministry of Defence is a mistake. You suggested that this might be because they are so scared, particularly the Navy, that they
would have to take the costs involved with the transition out of their budget, which would be too horrible to contemplate. Might they not be scared of something even bigger than that: that this is such a major change that there would have to be a whole new defence review? After all, we spend more as a proportion of our GDP on defence than the great majority of NATO members, and might they not be scared that this defence review might result in a reduction in UK defence spending altogether?

Mr Francis Tusa: Yes, at the moment it is not probable at all but there is of course the fear that someone might ask whether we are really sure we should be doing this nuclear thing. You never know, someone might go through the figures and say that we have reached that stage where we can no longer fudge it and see it through. There will be a defence review after 2015 anyway, and it is amazing how many important defence decisions have now all been pushed to post-2015. We know that there is absolutely no room in the budget, at all. I come back to the fact that if someone has to find £4 billion for relocation, say between 2015 and 2020, bearing in mind that the amount of supposed uncommitted defence spending is £8 billion, that does not sound like a particularly good equation. They will be in a serious world of hurt and you will suddenly find that, if it is being found out of the MoD’s budget, the quickest way to find the money is to cut personnel and more regiments, bases and squadrons. The next quickest way is to cut kit. So yes, if the extra costs fall straight on the defence budget, you are going to be faced with an already pretty appalling budget bow wave and an extra tsunami crest on top.

The Chairman: As you can see from the vigour of the questions, you have provoked a good deal of interest and I am very grateful to you.

Mr Francis Tusa: Thank you very much.
WEDNESDAY 24 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witness

Elspeth Orcharton, Director of Corporate and International Taxation, ICAS, Jeremy Purvis, Reform Scotland, and Professor Jim Gallagher, Nuffield College, Oxford

Q623 The Chairman: Welcome and thank you very much for coming. I think that this is our final session, so we are not under quite the same time pressure. It has been a very interesting day. Do any of you wish to make a statement, or are you ready to go straight into questions?

Professor Jim Gallagher: I think that we are ready.

The Chairman: Let me start with a question that we have been debating through the day; it would be interesting to have your views. The SNP has said, at least for the time being, than an independent Scotland would continue to use sterling. What do you think would be the best currency option for an independent Scotland, from both a Scottish perspective and that of the rest of the UK?

Professor Jim Gallagher: This is an example of one of the many questions about independence that is inherently unknown. It is unknown for two reasons. First, whatever the present Scottish Administration say, they may or may not be in government in an independent Scotland if such a thing is created. Secondly, these things would depend on negotiations with someone else—in this case, in particular, the UK Government. From a purely economic perspective, there is no doubt that these islands, particularly the island of
Britain, are an optimum currency union. It has all the characteristics. It is a single market. Labour moves and capital moves. From that perspective, having one currency makes a lot of sense. But that produces all sorts of difficult governmental questions to answer, some of which I know you have explored with previous witnesses.

Jeremy Purvis: Reform Scotland and the Devo Plus group have not been basing our primary research on what the direct consequences of independence would be. We support the continuation of the UK and the strengthening of the Scottish Parliament and governance within Scotland within the UK. It may help the Committee to know that in my former role as a Member of the Scottish Parliament I served on the Finance Committee. In 2009 I wrote to the Governor about whether or not any representations had been made by the Scottish Government at that point with regards to the future currency under the then Scottish Government’s plans for having a separate currency. The reply that I received, which I will supply to the Committee if it is of interest, was interesting. He reiterated to me that they operate under the Bank of England Act 1998, which, among other things, is for maintaining price stability and, subject to that, for supporting the economic policy of Her Majesty’s Government. That draws the very clear case that, if the Scottish Government’s position is to use sterling, then the economic policy of Her Majesty’s Government may not be the same as the economic policy of a subsequent independent Scotland. The currency under which that country would operate would be run in terms of the economic policy of what would effectively be a different country. The Governor went on to say, “It would be a matter for an independent Scotland to decide whether it wished to continue to use sterling as its currency on this basis. It would not be possible for interest rate decisions to take account of inflation in an independent country with its own fiscal policy, in the absence of a proper monetary union framework”. Our perspective comes from having decisions made in the Scottish Parliament on tax and finance more closely linked with the current devolved areas of expenditure and policy, and this would draw some strong consequences to what the fiscal policy of the Scottish Parliament would be, even though the framework would be set by a different country. So while the First Minister has indicated his view of what an optimum currency union would be, in my view there would be consequential, and in many ways potentially significant, decisions on fiscal choices over and above what would be in the monetary union with regards to the pursuance of an economic policy of what would be a different country. It therefore is not something that we would support.

Q624 Lord Tugendhat: Many people argue that Scotland maintaining sterling would mean that one would have to enter a fiscal pact. In a sense, it would be like two people in the same bed having to share the blankets and not take up too much space, one of whom is bigger than the other. I wonder how you think this would work and how much freedom of action you feel it would leave the smaller party?

Professor Jim Gallagher: Shall I start on that one? The image will stay with me for a little while. The lesson from the current European difficulties with their connection to monetary and fiscal union is plain as a pikestaff; there is no doubt about that. Therefore, if the rest of the UK were to enter into a monetary union with an independent Scotland, it would have to consider the terms on which it was willing to do so. It would have to take that decision in the interests of its citizens and not those of Scottish citizens. What constraints might it wish to place? The first issue is really about the share of the blanket, as you put it. That is: how much of a deficit is the larger country prepared to allow the smaller country to run without feeling that there is going to be an effect on its currency? You might argue that the other could run as much of a deficit as it liked, because it could go bankrupt and the markets would punish it. I think that if I were sitting in the Treasury, I would say that there is always
a risk that the markets will think that we will feel obliged to stand behind an independent Scotland, and therefore the amount that it borrows is inevitably of interest to us. Some constraints on tax and spend are inevitable, I think, in this entirely hypothetical situation.

The interesting question, therefore, is, first, to what extent are those more demanding than the constraints which the Treasury place on Scottish public spending just now. There is no reason for them to be any less demanding, because the Treasury is no longer subject to any political pressure from Scottish MPs. The second part of this interesting question is whether, in those circumstances, the rest of the UK also wishes to argue for some constraint, not on the balance between tax and spend but on particular taxation. That is to say, are they interested, as a condition of monetary union, in reducing the possibility of tax competition? We have not seen that in Europe yet, although there were very strong hints at one point, when Ireland was being subject to a bailout. Governments, particularly that of Germany, were inclined to demand that the Irish policy of low corporation tax should no longer stand. It did, in the event; but it was not a surprising thing for the Germans to think about. The question for the UK is whether it would prevent a similar tax move.

Q625 Lord Tugendhat: The Irish position is interesting. I suggest to you that the Irish introduced a tax policy that has proved very successful. It has caused a lot of resentment among others. Others have tried to take it away from them, but they have kept it. It would be very difficult for somebody else to do what the Irish have done. The Germans, the French and others do not want to have a second one. The example of Ireland, paradoxically, will mean that it would be more difficult for other people to go down that road, because they have seen the advantage that Ireland has gained.

Professor Jim Gallagher: To respond usefully to that, there are many reasons why no other country would or will go down the road that the Irish have gone down. The first, certainly in the context of Scotland, is that it already has a substantial corporation tax base, which Ireland did not have at the time. Therefore, cutting corporation tax by half, which is the kind of thing that you would have to do to make the same reform, would have such a deleterious effect on the revenue that it is not all that pleasing a prospect anyway.

Q626 Lord Forsyth of Drumlean: To pick up the point that you made, Professor Gallagher, about how there would need to be a set of rules agreed between the two Governments in return for an independent Scotland using sterling as its currency, can you help me with two points? First, what would be the stick that would be applied? What would be the sanction? How would you enforce those rules? We have heard a pretty vivid illustration of how successful the Maastricht criteria were in respect of the single currency in Europe and even, in the case of Greece, how, with some help from Goldman Sachs, the Greeks were able to disguise the extent of their variance from the criteria. So what would the sanctions be in order to make this work? At the end of the day, if an independent Scotland wanted to use sterling as a currency and did not want to sign up to any deal or agreement, what is there to stop it?

Professor Jim Gallagher: It is easier to answer that question by dealing with the second half first. The answer is: nothing at all. What you might call the Montenegro option of dollarisation is open to anyone, but it is open to anyone who wishes to operate without a sophisticated financial system. This is what broken economies do. They allow somebody else’s currency to circulate in their area. It means that they can do without a central bank. They do not need a central bank; they simply allow dollars to circulate in their territory. They do without, and certainly do not seek to operate, sophisticated financial services systems that try to sell to the dollar area. Panama is a fair example of that.
Lord Forsyth of Drumlean: Sorry to interrupt, but can you develop that argument as regards what the consequences would be for Scotland, and then deal with my first question?

Professor Jim Gallagher: Certainly. If Scotland wishes to use sterling, one option is what is in the jargon called “dollarisation”—simply allowing the currency, sterling, to circulate in that area but not having a monetary policy of your own. If you do that you do not need a central bank because you have no currency with which the central bank would deal, but it is very hard in those circumstances to have a functioning financial services system which relies on all the promises made on liquidity and which you would have from having a central bank of your own. That is not a viable option for a country that has a substantial financial services sector. So dollarisation, although conceivable, is not realistic. So if you are going to use sterling, you are back to having a real monetary union. We do not have all that many examples of functioning monetary unions. The euro is a half-functioning monetary union; it is not complete. I think that one can probably go back to the Austro-Hungarian empire, but my knowledge does not stretch that far back. Apart from that, how central rules would work in a monetary union with two independent countries, nobody knows.

Lord Forsyth of Drumlean: I am interested in how they would be enforced.

Professor Jim Gallagher: Indeed, and so would I be in the circumstances. It is not at all clear how they would be. It is certainly the case that if there were to be a single central bank, rather than two central banks in a monetary union—of course there could be more than one central bank in a monetary union, as in Europe—presumably some of the levers that it could pull could be used for enforcement, and you could deny the Scottish Government liquidity. However, no one has thought this out—and I certainly have not done so.

Lord Forsyth of Drumlean: Without putting words into your mouth—

Professor Jim Gallagher: You would never seek to do that.

Lord Forsyth of Drumlean: I have in the past. Without putting words in your mouth, this idea of a fiscal agreement would essentially not be very different from the kind of relationship in the old Scottish Office days that one had with the Treasury, whereby you had to agree with it the extent of your borrowing and various criteria, and you had flexibility within the parameters to decide what your priorities were. Would it really be very different?

Professor Jim Gallagher: It could be different in two respects. First, I think the parameters would inevitably be wider. Secondly, they would include taxation as well as spending. Nevertheless, it is I think inevitably in the interests of the rest of the UK in a monetary union to be clear about how much borrowing an independent Scotland was doing.

Jeremy Purvis: I could certainly foresee a situation that could be worse than the former arrangement with the Scottish Office and the current arrangement for the establishment of block grant, because of the points that Professor Gallagher indicated. If the requirement still pertained with the Bank of England for setting monetary policy for prices and inflation, it would also be looking at what impact Scotland would have on that for the rest of the United Kingdom, and any monetary union would require the restrictions to be upon Scotland as regards the impact on the rest of the United Kingdom, not on Scotland. The interests of the Bank of England as regards its statutory framework would not single out Scotland. Therefore, the consequences of setting budgets, when it comes to making fiscal choices rather than spending choices, would add that extra element as regards the impact of inflation on the rest of the UK. When it comes to looking across the whole suite of what the impact
of taxes could be—corporation tax on the financial services sector, on energy and other elements—they would affect prices across the whole UK. We are still waiting for clarity in what the First Minister has outlined by saying, on the one hand, that he agrees there would be a fiscal pact but, on the other, that there would be a voluntarily entered-into agreement on monetary union with what effectively would be another country. We are still awaiting details and clarity as regards his indications on that.

Q627 Lord Forsyth of Drumlean: What impact do you think there would be from having different tax rates in Scotland and the rest of the UK? Also, how much scope is there to have differential tax rates, given that we have just, probably, agreed that there would have to be some kind of fiscal rules? To what extent would it be possible to have differentiation in tax? What would the administrative impact be? What would the impact be on financial services, savings, pensions and so on?

Elspeth Orcharton: If there are different tax rates in Scotland, either corporate or personal, we start by asking, “Different higher or lower?” We do not have any information about what the tax system for an independent Scotland would be. That would be driven by three things. The first is the expenditure side. What does Scotland need to raise in tax revenue to fund this expenditure? We do not know that at this stage. We do not know what the taxpayer base in Scotland actually is, although there are some derived statistics and approximations that HMRC has been able to extract from its information and statistics. We do not know what tax system would be adopted. At a very high level, we do not know what the split of direct and indirect taxes might be, and we do not know what our replacement for national insurance contributions might look like. If you look across the EU, there are wide variations in how tax systems are put together. All these things are features that need to be taken into account when considering tax reliefs. I do not think we should lose sight of the fact that those options, choices and calculations are still to be determined.

As a working assumption, if we had a tax system in an independent Scotland very similar to the one that applies at UK level, we do not know what the choices of the Government of the day would be. We could speculate that there may be a proposal to introduce lower corporate tax rates, assuming that the spending side could somehow be managed. We then have to look at the consequences of that for businesses, and they can be twofold. One is that there may be a movement of businesses into the lower tax regime in the same way that around the world at the moment businesses will look at their supply chain and the location of their business operations. There is a competitive market in corporate tax rates, so there could be effect on business.

The larger one, which perhaps has more administrative consequences than solely economic ones, is moving profits between business locations where there are already operations across the UK. There are profit-shifting opportunities, without moving the economic fundamentals, so the argument is that a profit arises in a lower tax jurisdiction than a higher one. That would mean that businesses operating across the UK would have to do something that they do not need to do at the moment, which is to be able to demonstrate to their corporate tax authorities and exchequers the basis on which each exchequer is getting a fair slice of the tax on any profits realised in those jurisdictions. At the moment, for example, there are considerable exemptions for small and medium-sized enterprises in the UK system. It is entirely open to speculation as to whether that would need to continue, or whether it could not, given that there are a number of large businesses—take a retail chain, for example—that are operating right across the UK that would have to go through an administrative process.
The only other point is about individual tax revenues raised. We know from some of the statistics that the Office for Budget Responsibility has produced that, from an income tax perspective, there is a slightly lower income distribution in Scotland when considered relative to the rest of the UK, meaning that there is a relatively lower proportion of Scottish income tax payers paying tax at the higher and additional rates. If that slice were to be taken out, that may have an impact on the tax revenue realised once you have separated the taxpayer bases.

Q628 Lord Hollick: Could we come to the question of how assets, liabilities and debt are divvied up in the event of independence, including your thinking on how oil reserves are divided?

Professor Jim Gallagher: Again, on the assumption of independence, there would have to be a sharing out of assets and liabilities. There is a simple start, which is geographical. At a very simple level, most assets which are within the jurisdiction fall to the country in which they are. Physical public assets—government buildings and so on—are easy to do. It is pretty plain that there is now an acknowledged likely international law consistent boundary at sea which would determine which country most of the oil fields fell into and therefore which country would have the opportunity to tax them. An interesting question there is the extent to which the promises that have been made to oil companies about the tax relief that they will get on decommissioning those platforms will be carried across into an independent Scotland. If that does not happen, Scotland would find itself with a lot of undecommissioned platforms and the problems that that can produce.

There are lots of non-real assets that would have to be split up. The most obvious one is the UK’s national debt, which, if I recollect correctly, works out at something more than £30,000 per household. On what basis would you share it out? I can imagine three possibilities. The first is on a historic calculation of who had benefited from it, which would be difficult to do because there would be arguments about who had benefited from the spend and contributed to the tax. The second is a straightforward population share, which is probably the most likely. The third is what you might call ability to pay: the proportion of taxable capacity that was in one jurisdiction or the other. That is where oil is relevant because at the moment, if you believe the estimates in the Scottish Government publication GERS, Scotland, although it has 8.3% of the population, has 9.3% of the tax revenue if oil is included. So, if you went on ability to pay, it could get a larger share of the national debt.

However, there are lots of other liabilities, the most substantial being unfunded public sector pensions. How do you share those out? Again, one might argue for who has the benefit of the public service, or, following that argument, where do they live, or one might argue for a simple population share-out. There is a whole host of PFI obligations, some of which are geographically fixed and some of which are not. There is a whole host of contingent liabilities, such as the decommissioning costs of nuclear power stations and so on. All those would have to be shared out in a broad negotiation. That negotiation would have to take account of just about everything within the Governments, and there are many issues on which the Scottish Government could be the demandeur in that negotiation, just because of the dynamic of the situation and the scale of who was asking for what. However, there are some cards that it would be able to play in a negotiation like that, the most substantial of which is what happens with the defence assets, notably at Faslane and Coulport. So it would be an enormously complex negotiation.
Q629 Lord Hollick: Are there any precedents that you can point to which would help those discussions to be navigated satisfactorily?

Professor Jim Gallagher: The only recent precedent that I am aware of is the split of Czechoslovakia into the Czech and Slovak republics. It was simpler, in that those were two genuinely federal republics. The principle of physical assets belonging to the jurisdiction of location was followed. The national debt was not very large, oddly enough; it was a communist country and only borrowed from itself. Even at that, the negotiations ran to some 3,000 agreements, not just for money.

The Chairman: So the conclusion that you draw from that is that if we went down this route, it would take a very long time to reach agreement.

Professor Jim Gallagher: In reality, I do not think that it would be possible to conclude the negotiations for years and years. I think they would have to come to some kind of deal, after the first two years, and realise that there will be substantial things for many years after that.

Jeremy Purvis: Of course, there are many assets which are, even now, publicly accounted assets, but they are currently in private operations. That adds an extra element to the consideration; private parties may well have funds that are an asset. That adds an extra complication. It is not necessarily a case of intergovernmental agreements, but there are things on top of that. If you think it is appropriate, at some stage we could give an observation in response to Lord Forsyth’s view on this question of tax flexibility.

The Chairman: You might do it now.

Jeremy Purvis: First, I entirely endorse Ms Orcharton’s point. We have written to both the Treasury and the Scottish Government, calling for much greater clarity about what the tax yield is within Scotland. There are many areas of taxes in the GERS documentation that are extrapolations from the UK figures, not actual yield. We make the point in our report about corporation tax that the Holtham Commission in Wales has done some very good modelling. You can draw different conclusions depending on how you calculate corporation tax, whether on economic activity in Scotland, which is the Scottish Government’s default position, or whether on businesses that are legally located in Scotland. No modelling has been done with regard to that, to our knowledge, so it harms the debate somewhat. We certainly think that for much more informed decisions to be made in advance of the referendum, there should be more clarity from all sources and from both Governments. We asked for the OBR to have oversight of the presentation of that information. We think it is very important that there is independent presentation and verification of that data.

The final point that I would make in regard to tax flexibility is that, if there are cases for the devolution of further taxes in Scotland, then we are aware that taxes have a somewhat disproportionate impact on what the Scottish budget would be. For example, income tax is 20% of what the Scottish budget would be; corporation tax 6%; North Sea oil and gas would be 16%—a massively volatile source of income which would have, therefore, a massively disproportionate impact on the Scottish budget and business, given the instability in that. When we calculated the standard deviation of the sources of taxes in the GERS documentation, that informed our thinking of what appropriate taxes would be devolved to meet our wishes to have greater accountability for the Scottish Parliament with the responsibility for raising most of its revenue, but within the context of seeking as broad and as stable a source of finance as possible so that the decisions made in adjusting tax are part of policy choices and are not made because of having to counteract economic instability.
**Professor Jim Gallagher**: Could I add something? There is a general view and understandable principle that varying any taxation is a distortion of market activity. Varying tax across the territory is a greater distortion. One of the great strengths of the UK is that it is not only a single market but a domestic market. Therefore, a perfectly good argument can be made that one should restrict the extent of tax variation. So across corporation decisions will be not made for taxation reasons rather than pure business reasons. That said, you might say of businesses, “Well, they would say that, wouldn’t they?” If Scotland were an independent country, it would have to make these sorts of taxation decisions and they would have an effect on the market. The market is full of these things. An example of an extraordinary range of tax variation inside a single country is possibly illustrated by Switzerland. It is not a system that we would follow, but there are immensely large variations in personal taxation and, in the end, the markets adjust to that.

**Q630 Lord Forsyth of Drumlean**: They also have permanent referenda, as I recall. I just wanted to make this point to Mr Purvis, which is that this question of yield is crucial. I do not know if you want to comment on that. One thing that strikes me about the yield argument is that it is not just about revenue, because there are differences. I think we had some evidence in this Committee that shows that the demography of Scotland will be very different from that in the rest of the UK. We will have a much more ageing population, which will affect the demand side of public service as well as the revenue side and will make a substantial difference. I do not know whether anyone has done any work on this, but yield seems to be a very important matter, which could be made worse by having differential tax rates. Would you agree?

**Elspeth Orcharton**: I think that it is a crucial point. Just to clarify, I am not aware, in my discussions with HMRC, that they are doing any work on the taxpayer base. They do not have the data to take the corporation tax position any further than they have taken it at the moment because that information, which would give the yield for corporation tax for Scotland, sits within the businesses and not within any reporting that goes to HMRC, so you are automatically into a derivation of a financial model, however that may be built. On the income tax side, a further point to me is that Scotland reflects probably the rest of the UK in having a very substantial dependence on its income tax yield on something like 5% of its taxpayers. It is a very small number of individuals. I am not aware of that information and I think a separate exercise would have to be undertaken to begin to even quantify that level, which is fundamental to the debate. It would be important for all sides to try to inform this debate.

**Professor Jim Gallagher**: If the Committee is interested in the data of this, I suggest that you look not at the tax system but at the ONS and the Registrar General’s data. They measure and project something called the dependency ratio of the population. Essentially, that is the ratio of people of working age to people not of working age. In both Scotland and the rest of the UK, that dependency ratio goes up markedly over the next 20 or 30 years. Interestingly, it does not go up by much more in Scotland, but the composition differs. The Scots seem to get older while the English seem to have more kids.

**Lord Tugendhat**: I am sorry, but could you say that again?

**Professor Jim Gallagher**: The dependency ratio is the proportion of the population, roughly speaking, under 16 plus those over 64, divided by the number in between. That number gets bigger for the whole of the UK. It gets bigger for Scotland and for the rest of the UK, but the composition differs. The Scots seem to get older while the English seem to produce more kids.
Lord Tugendhat: That is the best position to be in, is it not?

Professor Jim Gallagher: Quite so.

Q631 The Chairman: It was this demographic point that the Chief Secretary to the Treasury drew our attention to and put quite a heavy weight on last week.

Professor Jim Gallagher: Yes, he did, although I noticed that he talked only about age and did not talk about the under-16s.

The Chairman: That is correct; he only talked about age.

Jeremy Purvis: But also, Lord Chairman, when it comes to not only the demographic but also the taxpaying component of that demographic, what lies at the heart of Lord Forsyth’s point is what the earning and taxpaying age is, and whether that profile is different. In our second report, *Improving Social Outcomes in Scotland*, we analysed what the contribution of the tax profile was using the HMRC data. It is clear that the contribution made by low earners in Scotland for income tax is a higher share of the overall tax take for Scotland than for the rest of the UK. The tax profile in Scotland is also different from that in the rest of the United Kingdom at the top end, where HMRC does not even have the top three layers of UK categorisation of total income when it publishes its data for Scotland. For the UK as a whole, there is a £1 million range of income down to £500,000, £300,000 and £200,000. In Scotland there is just £200,000 and above. They do not even have the published data for £300,000 earners, £500,000 earners and those earning over £1 million. The tax profile is very different. There are two conclusions to draw from that, as to whether that is an inhibitor for tax devolution, or whether, if you wanted to have tax fiscal choices made within Scotland that are more appropriately linked to both the demographic and the different policy choices in response to it, that could lead to the conclusion that we draw: there is merit in having further tax devolution, so that you put in the hands of MSPs a greater choice of fiscal levers for them to be able to adjust and incentivise. If they choose to redistribute or incentivise, they therefore have a broader set of tax choices. That is within the UK. That is the conclusion that we drew from that.

Lord Forsyth of Drumlean: You could also draw the conclusion that the Scottish tax base is very vulnerable to people getting on their bikes and moving south.

Jeremy Purvis: Most particularly at the high end, yes. However, that should provide discipline to MSPs that does not exist. To some extent, that is the point of devolution: you devolve power with the discipline that comes with it, rather than simply having the only response being spending power. If you only had the option of adjusting that with spending power, that could create more moral hazard than if you actually had taxation powers.

The Chairman: Could we come now to a question that was much exercising Danny Alexander at our hearing last week?

Q632 Lord McFall of Alcluith: Just before that, Professor Gallagher, given that I represented Faslane and Coulport for most of my parliamentary life, do you have any views on the economic implications of independence for the defence industry, the future of the UK’s Armed Forces, and their assets and liabilities?

Professor Jim Gallagher: That is a big question. An independent Scotland would have a different set of defence requirements from those of the rest of the UK. You could be very unkind and say that those would be very small—that there would be a kind of Home Guard approach. Or you could say that they might more resemble those of Ireland than, say, Denmark, to take two slightly contrasting examples. Whatever they were, they could not
conceivably be an attempt to project power on a scale or at the distance that the rest of the UK currently does. The rest of the UK might well want to continue to have that capability. There is an interesting contrast there. That has implications for how you would divide up the existing Armed Forces. You cannot have an eighth of an aircraft carrier; an independent Scotland probably could not even afford to run an eighth of an aircraft carrier. Although the bases cannot be moved, it is pretty clear that, if there were a share-out of the kit, it would have to be quite fundamentally asymmetrical. It is almost certain that the views of the service men and women would have to be taken into account as well. They could not simply be allocated to one country or another.

That is the first point. The second is that—although I would not claim to know that someone has done a proper profit and loss account for the Scottish economy’s participation in the UK’s defence business—certainly, in your former constituency, that base has a big economic impact; there is no doubt about that. There are certainly other places where that is clearly true, the most obvious of which is the shipbuilding industry.

The biggest defence question by far, however, is not the economic effect of Faslane and Coulport but the defence effect. What can we do with this kit? Is it at all possible to move it? Would it be possible to negotiate its retention? If one accepts the view of the present devolved Scottish Government, it is clear that that would be unacceptable to them. It might well be something in the process of negotiation on independence, were that to take place, where the UK would come to the table saying, “You want things from us. Well, actually, we have something that we want from you”.

Q633  Lord McFall of Alcluith: The issue that obsessed Danny Alexander was that, if the Scottish Government issued its own debt, would there necessarily be a higher borrowing cost compared to that for the rest of the UK? What would the differences depend on? At the end of the day, would the UK not have to support a fiscal crisis in Scotland anyway?

Professor Jim Gallagher: To start at the beginning, if there was a sharing of the UK’s national debt on independence day, there would obviously have to be some mechanism for doing that. There are two possibilities. One is that the Scottish Government would promise to send a cheque every month to the UK for its share of the interest; alternatively, the very bills themselves could be divided so that one tenth, or 8.3% or whatever it was, became Scottish instruments, or 8.3% of the instruments became Scottish. That would have to be sorted first of all but, on day one or week one, the Scottish Government would have to begin to establish a track record of paying or not paying the interest. In the end, it is that track record which will determine how the markets judge it. Until it gets such a track record, it seems unlikely that it would be able to borrow money at the same rate that the UK borrows it, which has been borrowing it without defaulting since the Napoleonic wars.

The Chairman: It seems highly likely to be a considerably higher rate, does it not?

Professor Jim Gallagher: I have no idea. If you were the markets, you would be bound to attach a risk premium to any new country until it establishes a rate. How big that risk premium is, I do not know. It might depend on whether you thought that the rest of the UK would step in in times of trouble. There is a lot of history on this in relation to federal countries—the extent to which the central Government is believed when it says that it will not stand behind a sub national entity is reflected in the spreads on the national entity debt. I have no experience of the extent to which it would happen in these circumstances but it is interesting that until recently European countries which ought not to have had a good credit
rating got very good credit ratings because people thought that other countries would, in fact, stand behind them.

**Q634 Lord McFall of Alcluith:** What incentive would the UK have to step in in times of trouble?

**Professor Jim Gallagher:** The same incentive it had to give support to Ireland: good neighbourliness.

**Lord McFall of Alcluith:** In other words, a neighbouring country is too big to fail.

**Professor Jim Gallagher:** Wrong to let it fail.

**Jeremy Purvis:** If the Committee looks at the GERS documentation that the Scottish Government published—I admit that they have an inconsistency in part of their arguments, but it may be helpful to get an understanding of what their thinking is—they categorise the financial intervention funding as spread by population share, as they believe that all parts of the UK have been helped, rather than recognising that RBS and HBOS were Scottish banks, although they take a different view on categorising North Sea oil geographically. They have a different perspective on what a UK benefit and what a Scottish benefit is.

The only point that I would make is that, when we have been looking at the overall figures, if we take the David Hume Institute’s work looking at the theoretical basis of what Scottish debt would be, under any objective view the profile would be higher both as a percentage of GDP and, certainly, as a percentage of what the Scottish budget would be, than for the UK as a whole. All the objective views have looked at that; it is not dramatic, but it is still higher. It will come down to a judgment—with the same level of debt profile, with the capacity for revenue raising within Scotland and, in the future, once the source of North Sea oil revenue declines—as to how sustainable that would be for the long term. The point that I have made previously is that this will be an irreversible decision in 2014. It is not a decision for the next 10 years, where we can go back. So it is a question of taking a very long-term view, and taking a long-term view of the viability of the sources of revenue that would underpin any sizeable country of 6 million people.

**Q635 Lord Levene of Portsoken:** How damaging would uncertainty be over how the tax system and other aspects within an independent Scottish economy would operate?

**Elspeth Orcharton:** The view of our members is that any uncertainty is bad for two groups. In terms of business, it just gives them an additional risk to consider in looking at financial projections. Even within the UK tax system and its continuous changes, however, we have called for certainty and stability, so we are not the biggest supporters of change from the uncertainty perspective. In terms of individual taxpayers it is important, if you wish to support compliance with the regime of the payment of tax, that there is certainty and clarity as to where obligations exist and how they should be met. Beyond that, it is a business uncertainty. What I would say is that a lot of our members are as concerned with another point that has not been raised today, which is the scale of changing any tax system from something in the UK to something in an independent Scotland. We do not know what that is, but the scale, process, energy and time commitment that that could absorb is almost of as much concern as the uncertainty.

**Q636 The Chairman:** Is that the purely administrative cost of managing a new system?

**Elspeth Orcharton:** There is the straightforward administration of having a different form, return, obligation or filing date, or whatever, for which there would be a compliance level.
Professor Jim Gallagher, The Institute of Chartered Accountants of Scotland (ICAS) and Reform Scotland—Oral evidence (QQ 623-640)

think that another issue for a number of organisations is that they think that they would be required to contribute and consider all potential consultation documents that come out, to look at the way a new tax system is being put together and to consider whether it is a coherent piece or will have unintended consequences. Also, I suppose that our members in this context are the tax professionals or the finance professionals dealing with tax, who are obviously going to have to try to understand and explain the changeover and the new administrative aspects internally to their boards, their staff and their employee base.

Professor Jim Gallagher: Could I add something to that? It is a smallish example of a very large issue that has not been properly discussed as yet. One of the major shifts that will happen were Scotland to become independent is the disentangling of UK institutions and services that are provided in and to Scotland. Two very major ones are the tax collection system and the benefit payment system, both of which are operated on a geographically blind basis across Great Britain and, at least in terms of tax, across the UK. If you receive your correspondence about national insurance contributions, it is from an office in Newcastle, wherever in the UK it is delivered. If you pay your tax, it does not depend on where you live. Critically, the IT systems that underpin each of these are single IT systems. In both cases, you will see a great difficulty in making any change to them. The minimum expectation is that an independent Scotland would have to negotiate shared facilities for a period of time with the rest of the UK. Otherwise, in practice, they would not be able to apply taxes or pay benefits. So some continued sharing, for a while, is inevitable. I do not regard the argument that you can share these things for ever as at all sustainable.

The Chairman: It is a very interesting further example of the transitional cost.

Professor Jim Gallagher: It is a huge transitional cost.

Q637 Lord Forsyth of Drumlean: On that point, I was just thinking that if I were on the negotiating team and people had voted to break up the United Kingdom, there would be all these issues. You have the First Minister taking the position that he is not going to be responsible for the debts of the Royal Bank of Scotland, which are in the area of £47 billion. It is difficult to see how one is going to reach agreement very quickly. What then happens if they do not reach agreement very quickly? The people will have voted, and if Mr Salmond is taking an intransigent position which is ridiculous, like not being responsible for a share of the bank’s debts, how would this be resolved? Would it be resolved by the courts or would we just have a period of huge uncertainty? The more I have listened to this this afternoon, the more I have thought, “This is going to be a complete nightmare”. How would you resolve it? Wearing your old hat, Professor Gallagher, as a Civil Service fixer, how do you think that this would be sorted?

Professor Jim Gallagher: The defining act of the creation of independence for Scotland would be as it was for decolonisation—that is, Westminster would pass an Act of Parliament declaring that it would no longer make laws for Scotland. It would depend on a very unpleasant game of brinkmanship, I fear, if these negotiations begin with bad will. There might well be a point at which Ministers say, “We’re passing that Act and you’re on your own”. Alternatively, there might be a point at which Scottish Ministers say, “If you don’t pass that Act, we will make some kind of UDI as the political authority”. These extremely difficult negotiations could only work with deep good will on both sides. I say this because an academic with a sense of humour invited me to give a paper on this subject. It is very difficult to see how it can be done without the strongest desire for co-operation on both sides.

Lord Forsyth of Drumlean: But if there were a problem, how would you resolve it?
Professor Jim Gallagher, The Institute of Chartered Accountants of Scotland (ICAS) and Reform Scotland—Oral evidence (QQ 623-640)

Professor Jim Gallagher: Politically, not legally.

The Chairman: But the range could be very considerable. Of course, the respective interests of the two negotiators are very different: one is a demander, and the other is having to respond.

Professor Jim Gallagher: That is why I say that in some respects the Scottish Administration would be the demandeur on this. But they have some cards thus it can play—notably the defence card.

Q638 Lord Tugendhat: May I just take up your answer to Lord Forsyth? I do not know quite what you meant. In the case of Ireland, Canada or Australia, for instance, there was a Government of Ireland Act, which went through Parliament, or the Government of Canada Act back in the 1860s. That was the formula that would go through. We are assuming, because that is what the two heads of Government have agreed, that they would both be using their best efforts and so forth to make it go smoothly. None the less, the sort of problem that Lord Forsyth has mentioned could arise on some technical issue, like tax. Were it to do so, yes, political resolution would be good, but it may or may not work. To what legal authority would the aggrieved citizen appeal?

Professor Jim Gallagher: I am not sure that there is a legal authority, but if the disagreement or problem arose before Westminster had legislated in the form of the Government of Canada Act, for example, then in principle the UK courts would have jurisdiction over the actions of both sets of Ministers. If the problem continued after Westminster had given up jurisdiction, then obviously the UK courts would not.

Jeremy Purvis: Part of our consideration for our third report is to look at how we would put our Scottish Parliament on a permanent footing, where powers are vested from Westminster on currently devolved areas. We have been looking at a similar approach to the Statute of Westminster, not for the purpose of Scotland becoming independent but for the purpose of permanently vesting legislative authority. Crucially, we would consider that the Supreme Court as constituted would remain as an arbiter, although both Parliaments would be a party to it if there were a dispute between Parliaments. The point that Professor Gallagher is correctly making is that there would no longer be a UK Supreme Court if Scotland had indicated so through the referendum. While there would be political resolution for many of these issues, as has been said, what would still be outstanding is that very many private interests would depend on decisions that are made. Depending on whether or not they have made long-term investments based on assets, where they reside and whether they believe that the results of the negotiations are appropriate to and consistent with what was in the Scottish Government’s White Paper—the Scottish Government have promised to publish it next autumn as their prospectus for independence—they may well seek redress in both the Scottish courts and in what would effectively be the English courts. What would still be the same is that Scots law would operate. The UK Supreme Court would not be the arbiter of that.

My final point is that you may to wish to talk to Mike Russell, who is the current Education Secretary in the Scottish Government. He held a view at one stage that it would require a second referendum for the people of Scotland to ratify the results of the negotiations. They could be dramatically different from what the prospectus of independence would be.

Lord Tugendhat: I think, with great respect, that it is rather odd to hear Scots talking in terms of a second referendum in Scotland.

Jeremy Purvis: I agree that his position was odd.
Lord Tugendhat: You vote in the coming referendum and we do not. However, if an agreement is reached between the United Kingdom Government and the Scottish Government and there is a referendum, we vote too—we would have to agree the terms, not only you, so there is a double jeopardy. We do not have a vote this time, but we would have a vote the second time.

Jeremy Purvis: I was simply indicating that that was the position that he held. I do not want to be in that situation at all; one vote is enough as far as I am concerned.

Lord Tugendhat: You might accept Alex Salmond’s terms, but the people of England, Wales and Northern Ireland might not.

Jeremy Purvis: I suspect that his position would be that that would be a matter for the rest of the United Kingdom. To refer back to that position, with clarity on what the process would be, looking at how we could have a settlement within the United Kingdom, from our perspective we want to be as clear as we possibly can so that the people of Scotland are aware what the consequences of a no vote would be if there is to be further devolution. Our view is that it is incumbent on those who are proposing independence to outline to people that there is, equally, a clear consequence of what happens.

Q639 The Chairman: I think that you heard part of our last session, when our witnesses had no clear idea of what to expect before the first vote—all the consequences for their industries were going to follow later. I think that there will be a very compelling case for a second referendum, and there would be huge debate in the rest of the United Kingdom about some of the negotiations that were being undertaken by their Governments. There will be a lot of political pressure.

Professor Jim Gallagher: A perfectly rational argument was made for a two-referendum approach by a number of academics some years ago in a book about this process. Their argument was that the first referendum should be about mandating the Scottish Government to go and see what kind of deal they could do. Once they had that, some sort of deal would be put to the people for endorsement. Neither Government has followed that approach. Actually, it was never realistic, because no Government had the incentive to do such a deal. The consequence, however, is that we are inevitably going to go into this referendum with substantial uncertainties about what independence means. There are lesser but still real uncertainties about what a no vote implies. The uncertainties about independence are structural and existential. You cannot know what an independent Scotland would do; you can speculate. Nor can you know what kind of negotiation will take place. The best you can do, as a voter, is to make the best educated guess you can as to how it is going to turn out, assessing what information you find, and make a judgment accordingly. You will forgive me if I put in a commercial for the forthcoming book on this subject that I have just concluded.

The Chairman: I follow that. The purpose of our inquiry is to try to illuminate voters’ minds as to all the issues and possible consequences of a yes or no vote. It is certainly very clear from the hearings that we have had that so many of the key issues—you have mentioned defence, for a start—will have to be negotiated after the vote has taken place. That looks almost certain. The political pressures on some of the potential decisions taken in these negotiations, and the pressure to challenge some of them, will be immense.

Professor Jim Gallagher: Indeed they will. There are few precedents that can help us. The only two I can think of are the aforementioned Czech Republic and Slovakia, but in that case both sides wanted separation for their own reasons. The only UK example that we are aware of, which is not so happy, is Ireland in 1922 where the negotiations produced civil war.
afterwards. There are not a great deal of precedents. In the event of a yes vote—let us be clear that we are talking about the event of a yes vote—much will lie in the process afterwards.

**The Chairman:** Time is running out. I am looking to my colleagues to see whether there are any other issues that they want to raise.

**Q640 Lord Forsyth of Drumlean:** One tiny point on this: while all this uncertainty and argument is going on, have you reflected on what the likely reaction might be south of the border? I am conscious that you mention the Czech and Slovak example. We had some evidence that in the Slovak example they actually pressed for devo-max and in the end the Czechs thought, “You want to have your cake and eat it”. There was pressure from the Czechs to kick them out of the union. I just wondered whether, if there is a lot of uncertainty and unreasonable negotiation, there might be the proverbial English—or, in this case, England and the rest of the UK—backlash?

**Professor Jim Gallagher:** I have two thoughts on that. First, what the Slovaks pressed for was not devo-max, because they already had a federal country. Undoubtedly, however, the dynamic of that was that the Slovaks were kind of dumb enough to ask when the Czechs were ready to say yes—in the end, to be fair, it has worked out well for the Slovaks; let us be even-handed about that. What we see in England is some increase in the salience of this issue: people have noticed. Since 2007, Scottish opinion on independence has not shifted, but English opinion has. That is quite significant. If you want a story, look not to Czechoslovakia but to Quebec, where one of the factors which clearly influenced the second referendum on secession was the very strong message from the rest of Canada that it would like Quebec to stay.

**Elspeth Orcharton:** I have a very quick comment in response to the point about all the uncertainty, and the political process and debate about that. This has been felt very strongly in ICAS in relation to our public interest role. We have an interest in trying to inform, taking the debate forward and seeking resolution. We will be continuing our series of papers looking at and asking questions, trying to elicit better clarity or certainty on positions. Fair enough, it is not laymen who really feel that this debate needs to be taken forward on so many fronts. We are perfectly willing to contribute to that by asking questions. We are conducting some independent research as well, on decisions made about tax in the Czech/Slovak countries and some of the others, to see what lessons have been learnt and what evidence can be gained from there. I would be very happy to share that in due course.

**The Chairman:** We have had witnesses on the Czech position and I am bound to say that I drew from it that there were not many parallels with the issues that we face now. Thank you all very much indeed for coming. It has been a very helpful end to a very constructive day. We are very grateful to you.

Q918 The Chairman: Sir John, thank you very much for coming to our final session in public, actually, of this particular inquiry. The Bank of England and the governor declined to give evidence to us, perhaps for understandable reasons, but the subjects we would like to explore with you are absolutely critical in our report. We are very grateful to you, as a former deputy governor for financial stability of the Bank of England, giving us this final evidence. Can I begin by asking a question you have heard we have put to others, but it would be helpful to have your view on it? John Swinney would like an independent Scotland to use sterling as its currency. Could a Scottish Government use sterling without the agreement of the Government of the rest of the UK? Would it be in the rest of the UK’s interests for Scotland to continue using sterling?

Sir John Gieve: As a preliminary, I should make clear I left the Bank three years ago, so I do not speak for them.
The Chairman: I understand.

Sir John Gieve: Indeed, I suspect that many of you know more about this than I do. These are personal opinions drawing on my experience.

On the question “Could Scotland continue to use sterling?” it is not quite clear what he meant by that but, in principle, yes. You can have currencies that cross different territories. Notably, effectively, Ireland—the Republic—used sterling as their own currency for many years so, in principle, that could happen. Having the Bank of England as their monetary authority and central bank, of course, goes a lot beyond that. There is the question of bank notes, the terms on which any notes were issued, and of course Scottish bank notes are already issued. There is the question of government accounts with the Bank of England, which still I think manages—it certainly did when I was there—the top level and high-value accounts for the Government. There is the question of clearing and settlement; there are the open market operations and whether Scottish banks would participate in those; there is the discount window and lender of last resort. There is a whole gradation of things that central banks do, and I guess there would have to be a negotiation over all of that list to decide which bits applied to Scotland.

On the question of whether it is in the interests of the rest of the UK, I guess, as a member of the rest of the UK, it would be convenient not to have to change my currency going on holiday or for business to Scotland. There would be some benefits in not having that inconvenience, but it depends how far down the list you are going to go.

The Chairman: But some of these issues are really very important. You probably heard our earlier exchanges with the Secretary of State. We know from John Swinney’s appearance before us last week that he was wrong in saying that the Scottish Government had been involved in discussions with the Bank of England. To what extent do you think these need to be sorted out before they vote on the referendum, or can they simply be left to negotiations afterwards?

Sir John Gieve: He also said that he was going to produce an issues paper that set out the UK Government’s views on these issues, and that might clarify their attitude to some of these questions. A lot of this is for the UK Government and Parliament, not for the Bank of England. When Scotland becomes independent, the Bank of England remains the bank of the United Kingdom and is subject to Westminster law and the Westminster Government. The decision, if you like, on how far Scotland continued to use or have access to the central bank would be an issue for the Government—this Government—

The Chairman: The UK Government.

Sir John Gieve: —to some degree. Just going back to the basics of notes and coins, I suppose a Scottish Government could pass a law saying that English notes are legal tender in Scotland. Actually, English notes are not legal tender at present; no notes are legal tender in Scotland, but coinage is throughout the UK. If they are an independent Government, they could, I think, say that they would settle their debts in English currency. It would then be a question for the rest of the United Kingdom Government to decide whether they were content for that to happen and, if not, what measures they might take to prevent it if they did not like it. There are a lot of mechanics in that. There is a note circulation scheme to try to ensure that there are enough notes in all parts of the UK at all times, which is run by the Bank of England, so there would be a question: is it going to run a note circulation scheme which covers Scotland, or is it only going to make sure the notes circulate round the rest of the United Kingdom? There are a lot of practical issues behind this.
Q919  Lord Tugendhat: We are really covering a whole lot of questions almost as one, Sir John. There is a distinction, as I think everybody now is fully aware when they look at the euro area, between the currency area having a common currency and the other arrangements that flow from it. I wonder therefore whether you feel that the Bank of England could provide lender of last resort services and the other services. Presumably it could, just as it is intended that the ECB should provide a number of services to a number of countries. This in effect would involve a banking union and perhaps a fiscal union as well between the independent kingdom of Scotland and the independent kingdom of England, just as we are seeing in the eurozone.

Sir John Gieve: First of all, on lender of last resort, it is important—

Lord Tugendhat: And the other services.

Sir John Gieve: Yes. Just on the lender of last resort: the bit that the central bank does, traditionally, is lend on good security to banks that it considers solvent. It takes collateral against that lending. There is a stage beyond that when the bank is not solvent or is not certainly solvent and someone recapitalises it or guarantees it. That is sometimes called lender of last resort. That is not the traditional central bank role; that is the Government’s traditional role. For example, we lent a lot of money to HBOS in expectation of a recapitalisation and the Government put the money into the bank. On that point, let us suppose you have a large Scottish bank—you do have one large Scottish bank still. The Bank of England might lend to it if it thought it was solvent and would repay, but it would take account in doing so of the strength of the fiscal covenant that might lie behind it. The Bank of England deals a lot with Deutsche Bank, which is regulated in Germany and is a German bank. Clearly, it has to be solvent under the normal tests but I dare say that the Bank of England takes some comfort from the fact that the German Government is definitely able to support it, should it wish to do so. On the other hand, you obviously had the Icelandic banks where that was not the case. In the end, we did put a lot of money into saving Icelandic depositors, but I do not think anyone would be keen to repeat that experience. The fiscal covenant that lies implicitly behind big banks is important in how far the Bank of England would be willing to deal with them in any of these stages, whether it is open market operations, settlement or extraordinary liquidity.

Sorry, that was just the first part of the answer. Is it conceivable that the UK Government could decide to, so to speak, leave things as they are—ie, with an implicit guarantee or whatever? I would have thought that they would think very hard before doing that, precisely because of the experience in the rest of Europe.

Lord Tugendhat: The link between the banks and the sovereigns.

Sir John Gieve: Yes, I think that is right.

Q920  Lord Smith of Clifton: You have almost answered the question, but if the Bank of England were to provide services such as clearing and lender of last resort to an independent Scotland’s institutions, would it be necessary for the Bank of England under the Prudential Regulation Authority to regulate the Scottish institutions? Or are you saying otherwise—if we were happy with things as we are with Deutsche Bank but we were not with the Icelandics? Where do we stand on that?

Sir John Gieve: This also goes to the question you were discussing earlier about whether Scotland would remain in the EU, because under EU law or indeed under the European Economic Area banks have rights to operate in different parts of the area. The Bank
probably could not wilfully decide not to deal with a Scottish bank or a branch of a Scottish bank that met the declared criteria any more than it can decide to refuse to deal with a German bank, if it is inside the European Union. That of course does not apply to supplying ELA, which is exceptional support outside the published schemes, and the assumption, which I think has been reconfirmed by the agreement just reached between America and the Bank of England, is that in resolutions and recoveries the sovereign for the territory where the bank is registered would take responsibility for resolving and, if necessary, supporting the bank in question.

On this question of regulation—would it be necessary to regulate the Scottish institutions?—not really. It would not be necessary but, in deciding what facilities to offer and how far to deal with a bank as its counterparty, the Bank of England would want to take account and some reassurance of how tightly it was regulated. If it was satisfied that there was a Scottish regulator operating to identical standards as operate in London and so on, it would probably be content with that. It might not be efficient but—

**Lord Smith of Clifton:** But you might start off by being content but, over time, if things deteriorated in some sort of way, one would constantly have to hold this under review.

**Sir John Gieve:** Yes. I thought it was unclear under Mr Swinney’s testimony whether he was saying there would be a separate PRA in Scotland, we are going to have two regulators in the UK. I was not sure how many of those he was going to replicate in Scotland and how far he was going to rely on, for example, the Bank of England to do prudential regulation as well as set macroprudential policy.

**Q921 Lord Forsyth of Drumlean:** May I just ask something, being devil’s advocate for a moment? I understand the position you are describing in terms of the role of the Bank of England as lender of last resort but, if we think back to 2008 and the collapse of the Royal Bank of Scotland, and if we imagined that we had an independent Scotland on our borders, would not the reality be that an independent Scotland would be too big to fail, as far as the rest of the UK economy was concerned, and that the Bank of England would have to act because of the consequences for the economy overall?

**Sir John Gieve:** If you reached the same circumstances, of course. It would be a decision for the Government more than the central bank at the point of crisis. Even the decision to provide exceptional liquidity support to Scotland was approved by the Chancellor here. Yes, of course the British authorities could face a very unpalatable choice. Arguably we came very close to that with Ireland, which is an independent country. There was a question of whether we should help them. There was quite a political debate about that—whether we should join the European support package for the Irish. We did, because the Government here said, “It is very much in our interests to prevent the Irish economy breaking up in disarray”. That would be even more so with Scotland.

**Lord Forsyth of Drumlean:** One has to bear in mind that the reason that the union came into being in the first place was because Scotland had gone bust, because of a property bubble. It is hard to imagine that, in a real crisis, England would not have to intervene. Presumably the price of so doing would be very much higher, as was the case with Ireland, where we lent them the money, I think, at 6% and we were borrowing it at 0.5%.

**Sir John Gieve:** Yes. As we can see with Greece, it all depends how serious the difficulties are. The price can come down. What you would be negotiating if Scotland became independent were the normal operating procedures and policies and what they could rely on, there is always a question of: if things go so badly off the rails, would you then think it is
in your interests at your discretion to step in and help? You may do, but that will depend on the circumstances and on what is going on in the rest of the United Kingdom. It will depend if there is the capacity in the rest of the United Kingdom to intervene, or whether they too are in difficulty, and so on and so forth. There is a difference between what you have the right to, because it is written into an agreement, rules, treaties and law, and what may happen. If you look at Greece at the moment, there are some people saying, “We will in the end be supported even if we don’t meet the conditions, because it is in the interests of the rest of Europe to support us”. They may be right, but it is a pretty brave bet. That would be the situation.

The other point about RBS, the Scottish bank, is that most of its operations are not in Scotland. Even its operations in the United Kingdom are concentrated outside Scotland, and it has got many subsidiaries which are actually incorporated outside Scotland. So it would be a messy situation because it is a major English bank as well as being a major Scottish bank.

**Q922  Lord Lipsey:** We have mostly been discussing the wide interpretation of what Mr Swinney said to us about macroregulation. Are there not also fairly major problems if you have two different regimes for what we used to call consumer regulation? There might be less heavy requirements on a Scottish insurance company than on an English insurance company, so English companies all move north of the border, offer cheap cut-price insurance that is not very regulated, that goes belly up and all the people in England say, “Gosh, it’s the English Government should have saved us from this. We don’t care that it was the Scots who did it. Give us our premium back.” Is that not quite a problem of regulatory arbitrage?

**Sir John Gieve:** Yes, it is, but it is not different in type to the problem that already exists within the EU. Suppose Scotland actually settled for a currency board arrangement, which would be more conventional than simply using the existing British central bank, but it tied its currency closely to ours and it had its own regulator. Yes, of course there would be constant options for tax and regulatory arbitrage which would no doubt be very irritating to both sides of the border. There would be costs incurred and, for any bank that operated on both sides of the border, there would be two sets of regulators so there would be compliance costs. Luxembourg has its own regulator, and it is separate from Belgium and Holland and has its own tax regime. We could live with them, but there would certainly be costs.

**Q923  Lord Shipley:** Reforms have been discussed in Europe, including a single financial regulator and access to emergency funding from the ECB. Are those reforms likely to strengthen the case for an independent Scotland joining the eurozone? Might it not be better to share a common central bank with other countries than to reach complicated regulatory agreements with the rest of the UK? To put it another way, in a sterling area Scotland is likely to be a junior partner; if it were to join the eurozone it would be an equal partner with the other countries.

**Sir John Gieve:** It would be a very junior partner in the eurozone. It would be a bigger partner in a sterling zone, it strikes me. Of course, if it became independent it might choose to join the euro, and the big consequences it has to think about are the economic consequences. Is that going to be the best arrangement for getting the policy that they need to sustain the Scottish economy and allow it to flourish? The negotiations they would have to go through to join the eurozone and to join the new regulatory arrangements in Europe are likely to be just as complex as the ones to, if you like, hang on to the rest of Britain. There are some common elements, but it is just as difficult. The real worries about joining the euro are, I guess, that we then do have a currency exchange with the rest of the UK
which does produce a barrier to trade and mobility, which I guess they think would be damaging, which is why they would like to stick with sterling.

Q924  Lord Forsyth of Drumlean: Can I just go back to this business of the position of a large bank like RBS? The present Governor of the Bank of England—I cannot remember when, but at some stage when we were doing an inquiry into another matter—made the point to us that one of the issues for Britain in terms of our financial crisis was the size of our banks and their balance sheet relative to the national balance sheet. Indeed, he has gone on to develop that argument for breaking up the banks and separating investment banking from the rest. I am just thinking about the position of RBS, which you quite rightly pointed out had got branches and operations in other jurisdictions. In an independent Scotland, which would have a considerably smaller balance sheet relative to RBS’s, notwithstanding that it is operating in different countries, and also, given that an independent Scotland would be a new country with no track record, I am wondering: would that mean that the ability to operate a bank of the size of the Royal Bank of Scotland in Scotland would be a very much more expensive and difficult undertaking? Might there not be a temptation for a large institution like the RBS to move south where the costs of capital and their position relative to the size of the country might be less adverse? I hope that is not a loaded question.

Sir John Gieve: It is a loaded question, and I am not sure I can answer it. I am sure that that would be an issue for whatever banks. I do not know how the company law position would be sorted out. After all, that is all to be decided too. They are currently registered UK companies with Companies House, so they would probably have a choice where to register, and they would certainly consider it, but I do not know which way they would go. The difficulty we faced in 2008 was that we came very close to having banks which were too big to save, not just too big to fail. So did Switzerland and so did Ireland. Only Iceland went over the edge, actually, and could not save them, and it brought the whole economy to its knees. Ireland came very close. We and Switzerland were one stage away. It is no coincidence that it is Switzerland and the UK that have been keenest to up the capital requirements on their banks and the liquidity requirements on their banks inside Europe, precisely because they have come very close to that vulnerability. If you were really sitting in an independent Edinburgh taking responsibility for RBS and the rest of the Scottish banking sector, you would have to think very carefully about what capital and liquidity requirements you set, because you might have a bank that was too big to save and therefore had to be in all circumstances proof against failure.

Lord Forsyth of Drumlean: So how would you cope with that? Ask it to go?

Sir John Gieve: What the Swiss have been doing is increasing their capital requirements very substantially, which I think is itself causing UBS and Credit Suisse, which are the two international houses, to reconsider their business models. You have seen UBS deciding to pull back, and I think both banks have considered splitting their operations in the past, to put their investment banking outside Switzerland. They have not done that yet, but they could. You would be in that sort of world. We are already in that sort of a world in the UK; we are going for super-equivalent capital requirements. As you know, there has been a debate: will HSBC leave? Will Standard Chartered leave? Will Barclays reregister in New York? That is an issue we face as the UK; it would be just as acute—maybe more acute—for Scotland.

Lord Forsyth of Drumlean: Going back to RBS and an independent Scotland: when you use a phrase like “reconsidering their business model”, what that actually meant in the case of UBS was firing tens of thousands of people and reducing the scale of their operations.
Sir John Gieve: Yes. That is their most recent decision—to pull out of some parts of investment banking, or at least to downsize them very substantially. In fairness, though, that is happening right across the banking sector, and RBS itself is at the moment changing its structure and its business very dramatically. If we are talking about three or four years’ time, RBS will be a different shape even to what it is today.

Q925 Lord McFall of Alcluith: Just to add to Lord Forsyth’s points: if you were a non-executive director of an insurance company in Scotland which had 95% of its business in the rest of the UK and 5% in Scotland, what advice and thoughts would you be bringing to the table for the chairman and the board of directors, if there were two regulators?

Sir John Gieve: As a non-executive director, I would think very carefully about all the options and collect all the information, and then make up my mind. I have got no idea. There is no presumption, or there has been much less of a presumption, in the insurance sector that you rely on the Government to bail you out. In fact, many insurers have gone bust without being supported, so that sort of worry—is this Government going to be able to stand behind me?—would not be so serious. On the other hand, you would no doubt make your choice on business reasons. Would it be easier to raise the money you need in London? Would you have as good a relationship with a new regulator in Scotland as you have with what will then be the Bank of England? Maybe you would have a better one; I do not know. I am not going to answer the question definitively.

Lord McFall of Alcluith: I understand.

Sir John Gieve: Clearly, any company in that position would be considering: “Where do I place my headquarters?”

The Chairman: Sir John, we are very grateful to you for coming and dealing with a number of the issues that we were not able to discuss with the Bank of England. Thank you very much indeed. That concludes our public hearings.
THURSDAY 25 OCTOBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witnesses

Councillor Gordon Matheson, Leader, Glasgow City Council

Q713  The Chairman: Mr Matheson, welcome to the Economic Affairs Committee. We are most grateful to you and the city council for allowing us to be here. You have looked after us very well—I would be grateful if you would pass that on to the staff. Amazingly as a Scot, this is the first time that I have actually been inside the building although I have admired it from the outside. It is a great pleasure to be in this magnificent building. Let me start by asking you a pretty general question. If Scotland becomes independent, what would you see as the main economic impact on Scotland, the west of Scotland and particularly Glasgow?

Councillor Gordon Matheson: Thank you, Lord MacGregor and my Lords. I am delighted to welcome you to Glasgow. This is a magnificent building that we are sitting in. In terms of the economic impact on Glasgow—and you will understand that I will focus on this city—I think the concerns around this whole issue of independence affect particular sectors of the Glasgow economy. More generally, the last thing that Glasgow needs is economic uncertainty. It does not help us at this stage in our ongoing transformation and diversification as an economy. It is exactly what we do not need as we grow our way out of this recession. We have a very clear economic strategy, the formulation of which has been led by the private sector, helped by the Glasgow Economic Commission, which has identified particular sectors of the economy that are working. As I would describe it, it has been a bit cautious that we should not back it.

Uncertainty does not help us. I would go further and say that there is not only uncertainty, which is unhelpful, but there is a climate of fear. I pick that up because there is not a week that goes by when I do not visit businesses or organisations within the city. I see that as a
A key part of my job. People do not want to put their heads above the parapet because they consider that that will have negative implications on their businesses. But when they speak to me, I think that it is incumbent on me, and my responsibility as the leader of this city—I see my role in this instance as broader than just being leader of the city council; I see it as being leader of the city—to give voice to those fears. Smaller companies in particular which have contracts with the Scottish Government have expressly told me that they consider they would be at risk if they even asked questions. They are also afraid to come into the public domain with their concerns because of the uncertainty and where that leaves them more generally in terms of their relationships with Government, whether or not it affects contracts. There is a sense of, “You’re either with us on this or you’re drummed out”.

In terms of some of the specific sectors in Glasgow, I have real concerns. We have a very significant financial sector in Glasgow, as you are aware. We identified that as an area that we wanted to grow in order to diversify our economy. There are 22,000 jobs dependent on that in Glasgow. Energy is another major sector in Glasgow. A number of power companies have headquarters within the city of Glasgow. As regards the comments that come through from there relating more generally to business, it would be helpful to know what the consequences are going to be and whether we are going to be part of the European Union. We absolutely need to know what the regulatory framework is going to be within which we need to operate. How do you unpick a UK network?

Another key area for us is defence jobs. Almost 4,000 jobs are already dependent on MoD contracts in the shipyards in Glasgow. No doubt like other Members of the Committee, I have visited the shipyards and I have been briefed on the quality of the work which is done there. I was told that the technology that is used, for example in the aircraft carriers that are being built on the Clyde, is comparable only to NASA in terms of the degree of sophistication. These are very proud, high-end jobs, which are absolutely dependent on MoD contracts. I know that the workforce there has grave concerns about the implications of that. Why would a Government in London issue a contract for defence ships to be built on the River Clyde in an independent Scotland? I do not think that it would happen.

Another area which I do not think has been highlighted, and which Glasgow has diversified into, is business tourism. Over the next seven years, the scale of business tourism equates to £1 billion. Glasgow is second only to London in terms of the number of business convention delegates coming to the city. Again, that did not happen by accident; it happened because we identified that as an area that we wanted to become expert in, and we are. But Glasgow City Marketing Bureau has told me that there is a significant risk to that business because of the uncertainty caused by the whole issue of independence, partly because the bulk of our business comprises organisations that are set up on a UK basis and book years in advance. These associations decide three, four, five, sometimes 10 and more years in advance, where to bring their business. The rest of it is international in nature. There is a symbiosis between the two because typically an association that is based in the UK will have Scottish members who will encourage their international colleagues to come to the city of Glasgow. The questions that are being asked there are the ones which are being rehearsed so often in terms of this debate: what is the context going to be? What is the political context? What is the currency? What country are we even coming to? That is another sector that I would like to highlight in Glasgow.

Finally, the council itself is a significant organisation within the city in terms of the council family. We employ around 30,000 people. In terms of the services we provide, you put out your rubbish and we will collect it. We are responsible for pavements, lighting, education and social and cultural matters. We are directly responsible for a whole range of services.
My concern is how secure the funding of public services will be in any potential independent Scotland. Part of that concern is because I think it inevitable that part of the UK debt would have to be assumed by the Scottish Government. Where does that leave us? Associated with that, and not only in terms of public finances, the credit rating of a potential independent Scotland is critical to Glasgow city council because we lend and borrow hundreds of millions of pounds every month. We do not keep the wage bill under the mattress. We have an enormous capital programme in Glasgow, partly as a result of the infrastructure associated with the Commonwealth Games. We also have a very ambitious school refurbishment programme, so we have a very significant but prudent level of capital debt that we are servicing. Approximately 10% of our revenue is used to service debt. The AAA rating is critical to treasury management in Glasgow and every council in the country. We also have 205,000 members of Strathclyde pension fund. That is an £11 billion fund. That is also fundamentally reliant on the retention of sound public financing and a AAA credit rating for our country. That is a long answer but I hope that I have touched on the relevant matters.

The Chairman: You have touched on a number of issues that we have been exploring here in our two-day visit. We are grateful to you for offering to come to act as a witness to our inquiry because most of the issues you are raising are precisely the issues that we feel are important in the run-up to the referendum. We set this inquiry up because we felt that there was insufficient public attention being focused on and insufficient investigation of and inquiries into many of the issues you raised. It is interesting that you say that you find that people are not willing to put their heads above the parapet. I have to say that we have detected this to some extent, so it is very helpful that the concerns of a lot of businesses and other organisations are brought to our attention in this way. You will probably find, if you read some of our evidence, that the points that you are raising about the AAA rating and the cost of borrowing were covered very heavily in our session last week.

Let me raise this one question about the uncertainty, and then we will go on to the detail of the others. There is a two-year period before the referendum vote, so there is that period of uncertainty. If it is the desire—this has become a bit more apparent recently—of the new Scottish Government, if that is what it is, to be a member of the European Union, that could take a considerable amount of negotiation over quite a period, so the uncertainty would continue for some time. Your highlighting that is something that is concerning us. I would like to go into some of the detail of our discussion.

Q714 Lord Forsyth of Drumlean: Just before you do that, could I just ask a question about the problem of people feeling intimidated and not being prepared to come forward? The related problem, which we discovered this week, is that perhaps the Scottish Government could not be entirely trusted in the way that they presented information to the public. This debate is taking place in the context of the people you are visiting, who are going about their business, not being sure what the facts are and who they can trust to provide the facts and how they can express views and questions. Obviously, this Committee is trying to present some of the issues in a neutral way and our report will do that, but do you have any thoughts on how this problem could be addressed? Is this something that the city council, for example, could try to provide some kind of forum on? Do you have any ideas about how we can get trusted, objective information presented to people so that they can make up their minds one way or the other?

Councillor Gordon Matheson: Thank you. The climate of fear even extends to asking the questions publicly. Not only is there increasing doubt over the complete openness or straightforwardness of the answers that you would get from the Scottish Government—I am
trying to be diplomatic—but people are afraid even to ask the questions because, for example, if you are an energy company and you ask a question about the regulatory framework, you will be told, “Why are you asking awkward questions of us at this stage? This is not helpful to us”—those are the kind of comments that I am hearing are coming back.

There are ways in which I think it would be helpful for me as leader of the council to take this matter forward. At our next council meeting, on 1 November, there is an administration motion that I will be moving instructing the chief executive of the council to look in detail at the implications for the council and for Glasgow more generally of this whole question of independence. That is a way to try to deal with the climate of fear and to give people a chance to express their views. I can understand why people would be afraid even to ask tricky questions of the Government. I am not afraid to do it. I consider it my responsibility to be that voice. Asking officers of the council to look at that and to take instruction to suss out what is going on more generally in terms of the city is one way of trying to break through that fog.

I know that the Committee has taken evidence from business organisations. I think that there is some evidence that they are more able to speak than their individual members are or, at least, I think they are building their way towards at least asking the questions. I fully anticipate that motion will be passed. I do not imagine that the main opposition party will support the motion, but we have a majority.

**The Chairman:** Councillor Matheson and colleagues, we have to catch taxis at 4.15 pm, so if we keep the questions brief and the answers are not too long, we will get through as much as we can.

**Q715 Lord Levene of Portsoken:** I have been an irregular but semi-frequent visitor to Glasgow and the difference in the city I see now compared with a long time ago is quite extraordinary. The recital of facts that you gave us in your opening statement shows how successful it has been. Two things concern me. We are totally impartial. We have no axe to grind, but I have not yet heard anyone who has spoken to us say how they would benefit from independence. The other thing, which you have underlined, is this climate of fear, which I find very disturbing. That people cannot have two sides to the argument and stand up and say “I think it is a good idea” or “I think it is a bad idea” is very disturbing. It is very unusual in this country. Do you have a view as to whether there are two sides to the story? In other words, are there lots of advantages if Scotland were to declare independence or is there only a downside?

**Councillor Gordon Matheson:** You need to look at these issues in the round, and my assessment is that there is not a strong case for breaking up Britain and that the negative implications, socially and in particular economically, massively outweigh any potential benefits that could arise. I am not saying that it is inconceivable that there could be some positives to being a sovereign state, but overwhelmingly I am convinced that it would be wrong for Glasgow. I am getting to the point where I am angry not only about the climate of fear—it is wrong that people should feel that way—but about the impact of the uncertainty. I agree entirely with Lord MacGregor. The uncertainty only ends in 2014 if there is an overwhelming vote against separatism. It continues for countless years thereafter if that is not the result.

**The Chairman:** Will colleagues focus on questions that are absolutely germane to this? We have a lot of questions to ask, but we will try to focus on the key questions.
Q716 **Lord Tugendhat:** If you want me to be absolutely germane on this, do you worry that the economic centre of gravity of an independent Scotland would shift east with greater dependence on oil and financial services and a bigger central government in Edinburgh?

**Councillor Gordon Matheson:** I have strong links with Edinburgh council. Internationally, Glasgow and Edinburgh are viewed as one economy, given that they are only 40 miles apart. In that sense, we are the second biggest economy in the UK, but I sense that there is a form of nation-building going on in Scotland already. There is evidence of a significant centralising tendency in the Scottish Government. I would expect that that would only get worse. For example, I know that in England a number of city deals are being struck between major core cities and the UK Government. We are miles behind England in that regard. There is a profession that cities are major drivers of the economy, so why not empower us within our city regions? In fact, there is an opposite tendency here. I shall give a couple of examples in terms of policy. There is the creation of a single Scottish police force and a single Scottish fire service. I could go on, but the evidence is increasingly that there is a centralising tendency, which I do not think is good for the Scottish economy.

Q717 **Lord McFall of Alcluith:** Are you suggesting that there is a dead hand of government in Edinburgh and that, with you being based in the west, there is an element of discrimination there?

**Councillor Gordon Matheson:** We as Glasgow get on with it and we do very well, thank you very much. We are the powerhouse of the Scottish economy, but we do not get breaks.

**Lord McFall of Alcluith:** In your opening remarks, you suggested that there is an area of approach in Glasgow which has perhaps been stultified by the present nature of the Government and by the debate on process, while policy and development has been left behind.

**Councillor Gordon Matheson:** Even your question helped to clarify my thoughts. My answer would be yes. As a specific example, the empowering of cities within city regions, which is happening in England, is not happening here because instead there is a form of nation-building going on in an awfy wee country. That is at the expense of Glasgow and our city region.

Q718 **Lord McFall of Alcluith:** As you know, I represented the Faslane and Coulport areas for many years as a Member of Parliament. That is in the Glasgow travel-to-work area, as well as BAE building warships in Glasgow, Rolls-Royce, Barr and Stroud, the National Savings headquarters, DfID and others. Mindful of those enterprises, are there any specific areas where independence would impact on the local economy?

**Councillor Gordon Matheson:** Yes, I think absolutely in terms of defence jobs. I am not clear what the Scottish Government’s policy is on defence, to be honest, but one assumes that if it is independent, it breaks up Britain. Those jobs that are reliant on MoD contracts will be lost. I see no other possibility. I am very concerned also about the other sectors that I touched on, such as energy, finance and business tourism or convention business, which alone supports 6,000 jobs in Glasgow.

Q719 **Lord McFall of Alcluith:** In my constituency, as you know, along the banks of the Clyde there was heavy shipbuilding and engineering. Although that ceased in the 1960s and 1970s, the legacy is still with us. In our local economy, bringing new jobs and new enterprises is still a difficult process. Given what could happen with Faslane and Coulport going and what could happen in areas here such as defence and shipbuilding, would you
agree that the regeneration and rebirth of industries is a long process, taking decades, and that it could take up a large part of Glasgow City Council’s agenda over the next number of years?

Councillor Gordon Matheson: I agree entirely. The Committee has already made kind comments about the way that Glasgow has developed and transformed. That is because we have had to. The transition of Glasgow in the 1980s was painful, but we have diversified as an economy. There is a real danger that that would be not only abandoned and stalled but reversed. Economic and social progress is not inevitable. I do not want to be wasting time on the independence question when what the people are interested in is, “Is my pension secure? Is my country secure? Is my son or grandson going to get an apprenticeship?” These are the questions and I think that our economy will be put at risk. I do not want my eyes taken off the ball, which is ensuring that Glasgow continues to develop and diversify as an economy, but that is the danger for Glasgow and Scotland resulting from this whole independence uncertainty.

Q720 Lord Levene of Portsoken: Councillor, how do you think the UK’s current joint public expenditure flows, including social security, healthcare, the Barnett formula transfers and defence spending, might be affected by Scottish independence?

Councillor Gordon Matheson: It is only reasonable to assume that they would be fundamentally affected in a way that I cannot see being beneficial to Glasgow or Scotland. The very fact that we do not know the answers to these fundamental questions creates precisely the kind of uncertainty that undermines business confidence.

Q721 Lord Forsyth of Drumlean: You touched on the issue of Scotland’s share of the national debt in your earlier remarks. Have you any thoughts on how the assets and liabilities of the United Kingdom might be divided between Scotland and the rest of the UK, what the impact might be on Glasgow and other major cities and, in particular, what the impact might be also on some private assets, such as pension funds?

Councillor Gordon Matheson: Divorce is an awfy messy business. There are 7,000 UK government agency jobs in Glasgow, so let us begin there. How you extend that into the areas of services, regulations and assets across what is a United Kingdom almost does not bear thinking about. That underlines the point made by Lord MacGregor: the uncertainty will only continue unless this matter is finally resolved in 2014. I just think that the implications are enormous and frightening and they create an unnecessary and unhelpful social and economic atmosphere.

Lord Forsyth of Drumlean: I notice from your biographical details that you were a marathon runner. If even you think that this marathon would be too long, that is a very interesting observation.

Q722 The Chairman: Let us turn to one or two issues that you raised earlier about the currency, and so on. If Scotland became an independent nation, which currency do you either expect or want it to use? You know that there are a number of alternatives: sterling, joining the euro and an independent currency. What is your view?

Councillor Gordon Matheson: That it would be the United Kingdom’s currency of sterling would certainly be my view. If, however, we were to vote for independence, I do not know what the currency would be. I am now in an area where I do not want to be, which is post-2014 and we have decided to break up Britain. Only then do the negotiations really begin—the negotiations with the UK Treasury and the negotiations with Europe. Who protects us
next time there is a banking crisis? There are so many fundamental questions and there are no answers. The Scottish National Party, whose whole purpose is to achieve independence, has changed its views on what the currency of Scotland should be. It was going to be the euro until the European monetary crisis, when it became politically awkward to say what it would do—no kidding. Then it reverted to the pound. Then questions began to be asked, “To what extent are you a sovereign, independent country, if you are going to keep the same head of state and the same currency? Wait a minute, I thought we had devolution.” In other words, I do not want to be there; I do not want even to be countenancing this, because it will cost jobs in Glasgow.

Q723 The Chairman: One of the key aspects is the position of the Bank of England as lender of last resort, and we have been exploring that in London and here. Obviously there would be strict conditions, just as there were would have been strict conditions if we joined the euro. One of the conditions is clearly the fiscal pact. One of our witnesses, Professor John Kay, has argued that it would mean establishing the principle of the Bank of England being the lender of last resort. The Scottish Government would borrow and would be responsible for their own debts, and the English Government would have no liability whatever. Clearly it would be cheaper for people on international markets if there were no liability for the debts of the Scottish Government. I wonder what you would feel about a situation like that.

Councillor Gordon Matheson: I think that I would weep, because the markets would take a devastating view of that. From day one we would be finding ourselves in that position. Public services in Scotland would struggle to be funded and business confidence would go through the floor. How do I speak to the 205,000 Strathclyde pension fund members when our credit rating is junked?

The Chairman: The fact that there are no other questions shows that you have been extremely clear and consistent in the message that you have given us. We are very grateful indeed to you for concluding our hearing. Actually, Lord McFall wants to ask another question.

Q724 Lord McFall of Alcluith: We have a couple of minutes. In our earlier sessions, it has been clear that this debate so far has lacked evidence and there has been an atomisation associated with it. There is no formula for ensuring that good information gets out. I have challenged a number of politicians and trade bodies on doing something about that. Would you be willing, as leader of a major council in Scotland, to assist individuals to come along so that in an objective way we can get the facts on the table and elevate the debate from the emotional to the factual?

Councillor Gordon Matheson: Yes. Let us try to counter the fear with some facts. In terms of Glasgow, earlier I answered a question about what the council intends to do, which is to instruct our chief executive and his officers to assess the implications, or at least to raise the questions. We are entitled to have answers on the implications for the council and more broadly for Glasgow. We will be working very closely with all organisations across the city. We are quite a tight outfit here. We have very strong links and I think that the wider social and business community in Glasgow recognises that the council is providing a leadership role across the city, not only on the council. We will be using our offices to ensure that our voice is heard and nobody is going to be cowed—certainly not in Glasgow.

The Chairman: Councillor Matheson, as I said, thank you very much for giving us such a clear message. When it is produced, we hope that our report will shed more light—we have
certainly asked a lot of the questions—on the implications not only for Scotland but for the rest of the United Kingdom. You have made your contribution to that extremely clear. I also put on the record our thanks to our other witnesses for giving us the benefit of their views and experience. I repeat our thanks to Glasgow City Council for enabling us to be here today. That concludes our session. Thank you very much.
Dr Karen Henderson—Written evidence

The Division of Czechoslovakia
(Prepared for the Economic Affairs Committee of the House of Lords)

Background to the division of Czechoslovakia

1. There are a number of major differences between the circumstances in which Czechoslovakia divided in 1992 and those that would pertain in the UK were Scots to opt for independence in a referendum. Among the most salient are that Czechoslovakia was a federation of two republics where in many issues the Slovak Republic had parity with the Czech Republic in decision making. This led to a constitutional and legislative gridlock which by 1992 required urgent resolution because of the particularly demanding nature of the post-communist reform process. However, in some respects the fact that Czechoslovakia was an unconsolidated democracy with an incomplete market economy made the rapid establishment of two independent successor states simpler to achieve.

2. It should be noted that no referendum on the division of Czechoslovakia took place although many citizens and politicians considered that this would have been the correct procedure. This was because it was unlikely that a referendum would have generated a solution to the complex constitutional problems the country faced. It was usually assumed that any referendum would be conducted in both the Czech Republic and the Slovak Republic.

3. Czechoslovakia became a federation following the Warsaw Pact invasion of August 1968. The Constitutional Act that came into force on 1 January 1969 banned ‘majority rule’ in parliament on a number of issues, including budgetary matters. This meant that in the upper house of the Federal Assembly (parliament), the Chamber of the Nations, where half of all deputies were Slovaks, bills had to be passed separately by the Czech and the Slovak halves of the chamber. On issues of constitutional import, an exceptional majority of three-fifths of all deputies in the Czech and in the Slovak half of the Chamber of the Nations was required to vote in favour for a bill to be passed. The lower house of parliament, the Chamber of the People, represented both nations proportionally, and therefore contained approximately twice as many Czechs as Slovaks. Both chambers were elected concurrently and had similar powers, which would be unusual in a democratic bicameral system.

4. The ‘Velvet Revolution’ which defeated Communist Party rule in November 1989 laid particular importance on the rule of law, and therefore required the Constitution to be amended or replaced in accordance with the existing constitutional procedures. This proved problematic, since the exceptional majorities required by the communist-era constitution were far easier to obtain when Czechoslovak politics was dominated by the Communist Party of Czechoslovakia than under democratic conditions when conflicts of interest were openly debated and contested.
5. The Federal Assembly (parliament) was democratically elected in June 1990 for a two-year period, during which time a new Federal constitution as well as constitutions for the Czech and Slovak Republics were to be passed. However, when the next elections took place in June 1992, these aims had yet to be achieved. This was due both to communist-era decision-making procedures proving dysfunctional in a democracy, and to the controversial nature of the issues under discussion. There was no agreement on the sequence in which the federal and republican constitutions should be passed. The Slovaks had major grievances relating both to the nature of their sovereignty, and to crucial issues of economic reform. Although it appears that the division of Czechoslovakia on 1 January 1993 was negotiated very quickly in a six-month period following the June 1992 elections, it should be noted that the alternatives to establishing independent states—that is, the possibilities for reshaping the Federation in a way that satisfied both Czechs and Slovaks—had been discussed at great length in the two-year period prior to this.

6. The democratic electoral system adopted for the 1990 and 1992 parliamentary elections encouraged the creation of separate party systems in the Czech and Slovak parts of the federation. It was a proportional representation system with a ‘five per cent threshold’: voters chose one party list of candidates, and a party obtained a proportional numbers of seats in parliament only if it obtained at least five per cent of the vote. However, so that parties attractive to the more numerous Czechs would not have an unfair advantage, the Czech Republic and the Slovak Republic were regarded as separate electoral territories for the application of the five per cent threshold. Consequently, a party gained no advantage in terms of passing the threshold for entering parliament by running in both the Czech and Slovak parts of the federation. There were no nationwide Czechoslovak parties with a strong electoral interest in adopting conciliatory political programmes that would appeal to both Czechs and Slovaks.

7. The most salient difference between the Czech and Slovak economies following the fall of communism was that unemployment rose rapidly in Slovakia. Slovakia had modernised later than the Czech lands, with much industrialisation taking place under communism. The economy was less diverse, with some towns heavily dependent on a single employer, and the closure of arms factories caused particular problems.

Events of 1992

8. The June 1992 Czechoslovak elections, which as in June 1990 held votes for both the Federal Assembly and the Czech and Slovak national councils (parliaments), produced a result that suggested that negotiations on the future of the Czech and Slovak Federal Republic would be even more problematic than during the previous two-year parliamentary period. The leaders of the Czech and Slovak parties that gained just over a third of the Federal Assembly vote in their respective republics, and nearly half the Czech and Slovak parliamentary deputies (some of the vote having been ‘wasted’ on parties that did not pass the ‘five per cent threshold’), held incompatible views on both the future of the federation and economic policy. In the Czech Republic, the clear leader was the federal finance minister Vaclav Klaus, an economist primarily interested in rapid economic reform, while the Slovak leader, former Slovak
Dr Karen Henderson—Written evidence

prime minister Vladimir Meciar, supported Slovak sovereignty and was more cautious on economic issues.

9. A major ‘democratic deficit’ in the division of Czechoslovakia was that neither Klaus nor Meciar had campaigned in support of independent Czech and Slovak states in the June 1992 elections, yet they agreed to pursue this option in their first meeting two weeks after the election because it was second choice for both of them and their first choices were clearly incompatible. Klaus’s party, like a majority of Czechs in opinion polls, supported a strengthened federation, though its election manifesto stated that it could come to terms with two independent states if a ‘functioning federation’ was not feasible. Meciar’s party, like many (though possibly not a majority) of Slovaks, supported a ‘confederation’, which could be loosely defined as a currency and defence union between sovereign states. Since Klaus would not entertain the idea of a confederation, and it would have been politically almost impossible for Meciar to backtrack and agree to a Czech-dominated federation, the election victors went ahead with pushing for the division of the state. Although internationally the Slovaks were generally at that time viewed as the republic striving for independence, in practice it was the Czechs who pushed the option through.

10. Scottish support for ‘devo-max’ or ‘independence-lite’ bears striking similarity to the Slovak preference for a ‘confederation’. However, the British have far more experience than the Czechs in negotiating and administering complex asymmetric relationships, and the possibility of a ‘middle way’ being negotiated in the UK cannot be discounted in the light of Czech-Slovak experience, particularly given that the UK is not under the extreme time pressure from the legislative ‘gridlock’ crisis that Czechoslovakia was experiencing in 1992. (One reason why the end of 1992 was set for the division for Czechoslovakia was that it was clear that the Federal Assembly elected in June 1992 would be unable to agree a budget for 1993.) The problems relating to the framing of referendum questions are similar in both cases.

11. Once the leaders of the two most successful parties in the June 1992 elections had decided to divide the Czech and Slovak Federal Republic into two independent states, the major question was how this was to be achieved. Although Klaus and Meciar became prime ministers of the Czech and Slovak governments respectively and therefore controlled the national councils of the two republics, the Federal Assembly needed to pass the law to end the federation. The bill on the Dissolution of the Federation was not finally passed in all parts of the Federal Assembly until 25 November 1992. Opposition to the bill focused largely on the failure to guarantee a referendum. There was reluctance to hold a referendum because it was likely that the public would oppose the dissolution of the federation, but this would not provide the political leaders with the means to run the federation effectively. It was also possible that if a referendum were held, independence would only be approved in one of the two republics, which would then be faced with the prospect of secession, which would be less advantageous than dividing Czechoslovakia into two successor states. By late 1992, Czechs appeared more likely than Slovaks to vote for independence.

12. From late October 1992, that is before bill on the Dissolution of the Federation had been passed, a number of constitutional acts, agreements and treaties were passed
that regulated relations between the successor states from 1 January 1993. For example, there was agreement on a customs union and the free movement of labour between the two republics, and issues such as mutual recognition of qualifications, health care and pensions were regulated.

13. The Constitutional Law on the Division of Federal Property was passed on 13 November 1992 after considerable political argument. The general principle adopted was that property should belong to the Republic in which it was located, and that other assets were divided 2:1 in favour of the Czech Republic, in line with the size of the two republics’ populations.

14. The treaty relating to the Monetary Agreement dates from the end of October 1992. It was considered unfeasible to create separate currencies by 1 January 1993, and the treaty obliged both republics to strive to maintain four conditions at least until 30 June 1993. The conditions were that neither republic should have a budget deficit greater than 10 per cent of budget receipts; that the currency reserves of both parties should not decline below the level of the value of one month’s imports; that there would be no speculative movement of capital from one republic to the other that would affect the banking system by exceeding 5 per cent of savings held in banks; and that there should be agreement on basic questions of monetary policy in the Monetary Committee. The Committee was to meet at least twice monthly and comprise the governors of both central banks and members named by them. Czechs and Slovaks had parity on the committee.

15. The Czecho-Slovak monetary union ended prematurely on 8 February 1993 largely because of speculative capital movement but also concerns about the Slovak budget deficit. Coordination of monetary policy was hard to achieve since fundamental disagreements on economic issues between the Czech and Slovak governments had contributed to the division of the state. The ruling Czech parties were particularly interested in economic reform and had little trust in the Slovak government’s competence in the area. The currency was divided by attaching stamps to bank notes. Citizens were only able to convert a limited amount of cash, as a consequence of which considerable sums of money saved at home was moved into bank accounts shortly prior to the division of the currency. The Slovak crown dropped by over 10 per cent compared to the Czech crown after the division of the currency. Long-term, the value of the Slovak crown was set at 30.126 crowns to the Euro prior to Slovakia joining the Eurozone in 2009. There are currently approximately 25 Czech crowns to the Euro.

Aftermath of the division

16. International recognition was generally unproblematic for both republics, and they were accepted as United Nations members in January 1993. The Europe Agreement establishing an association between the European Communities and the Czech and Slovak Federal Republic, signed in December 1991, never came into force because of the division of Czechoslovakia, and separate Europe Agreements with the two successor states were signed in October 1993 with updated wording.

17. The economic consequences of the division of Czechoslovakia are hard to distinguish from the effects of the rather different economic policies pursued by Czech and
Slovak governments from 1993 onwards. A second wave of voucher privatisation ensued in the Czech Republic, while privatisation was conducted in a less transparent manner in Slovakia. In the course of the third Meciar government (1994-1998), international confidence in Slovakia sank markedly both politically and economically, and in 1997 the country was not invited to join NATO and to start detailed negotiations on EU accession, unlike the Czech Republic, Poland and Hungary. However, independence permitted the two Dzurinda governments (1998-2006) to adopt fairly radical economic reforms, including the ‘flat tax’ introduced during its second term in office. Slovakia became an attractive destination for foreign investment and while it joined the EU and the Schengen zone at the same time as the Czech Republic, it has adopted the Euro earlier.

18. Although the division of Czechoslovakia lacked democratic legitimation, it has been a considerable success. Contemporary relations between Czechs and Slovaks are excellent on all levels. Although the standard of living in the Czech Republic remains higher than in Slovakia, economic development in independent Slovakia has been impressive, despite highly problematic government performance in the mid-1990s.

September 2012
TUESDAY 9 OCTOBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Baroness Kingsmill
Lord Lawson of Blaby
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Skidelsky
Lord Tugendhat

Examination of Witness

Dr Karen Henderson, Senior Lecturer in Politics, University of Leicester.

Q482 The Chairman: Good afternoon Dr Henderson. I am sorry about the delay, but this is our first week back and we had quite a lot of private business to discuss before this hearing. Welcome to the Economic Affairs Committee. This is the 10th public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. Copies are available in the room of Members’ entries in the register of interests. Thank you very much for coming. I will briefly explain the background to this. When we were looking to see whether there were any implications in other parts of the world and back in history that would have something to say of use to our inquiry, one of our previous witnesses recommended you in particular. We know that you are not an economist, but you are a specialist on Czechoslovakia. Therefore, I am very grateful to you for coming and for the paper that you have given us. I would like to start by saying that I realise that the background is very different between the United Kingdom and Czechoslovakia and you make that point very clear—the relative size of the two countries, the development of the economies and so
on. But there are areas that where there might be lessons for us. What are the main areas where the Czechoslovakia experience might be relevant to our inquiry into the possibilities of Scottish independence?

**Dr Karen Henderson**: Ironically, given that they did not hold a referendum, the problems of holding referendums on issues of dividing states is a lesson from the division of Czechoslovakia. At the time, Czechs and Slovaks said that they could not hold a referendum, even though constitutionally they were obliged to, because they could not even agree on the question. My argument to that was that by December 1992, the question would have been clear—“Do you agree with the division of Czechoslovakia into two independent states according to the law on the dissolution of the federation of November 1992?” They could then have listed all the other legislation and asked the public. They did not do that then partly because of the huge hurry they were in, given the pressures of post-communist reform, and because they probably would not have got a usable answer. Almost certainly, Czechs and Slovaks would have said no to division. But they would not have said yes to any clear pattern of how to carry on running the state, because the status quo, which is functioning in the United Kingdom, was not functioning in Czechoslovakia. But the idea that it is difficult to ask a question without knowing the details of how you are going to divide the country is a valid one. At one point, some in the federal assembly said that they would not pass the law on the dissolution of the federation until the law on the division of federal property had been passed. The argument that you need to know the terms before you can make a decision—and in the Scottish case there might need to be two referendums—is fairly reasonable. In the end, there is a difference between a referendum about making a decision, which referendums are very bad at because of yes/no answers, and referendums that are legitimating decisions that have already been effectively made by political elites, like the British referendum in 1975.

**Q483 The Chairman**: We are not looking at the constitutional implications, but the interesting question from this is whether people understand all the implications. Have they been set out before the referendum so that people will respond to the questions on the basis of knowledge and understanding rather than saying, “Well, that is all for the future”?

**Dr Karen Henderson**: Yes, in the Czechoslovak case, it was also that the political elites did not particularly want to involve the public. Another lesson that is crucial, particularly regarding the question of how long negotiations on dividing the state would take if there were a positive vote in a referendum, is that it has to be remembered that in the Czechoslovak case the Prime Minister of the largest unit in the federation was pushing for independence. When, for example, they set up commissions to decide on property questions, both sides had effectively put in people whose mandate was to push for division and for that to work. Part of the Czechoslovak experience is that if political elites agree, they can push through just about anything. But that again would probably be a major difference in the Scotland/UK case.

**Q484 The Chairman**: Turning to some of the economic implications, before the break-up, was there much market turmoil in the currency markets and so forth before independence and between both Czech and Slovak?

**Dr Karen Henderson**: You mean before and after dissolution of the state had been decided? Actually, not that much. One of the conditions for continuing the common currency for at least six months was that there should not be speculative movement of capital from one republic to the other. That was starting to happen, I believe, on the level of enterprises rather than private citizens, although private citizens discussed doing so at the time. But
Dr Karen Henderson—Oral evidence (QQ 482-499)

given the entire extent of economic turmoil in the post-communist reform period, which was much worse in much of the post-communist world than it was in Czechoslovakia, things really did proceed extremely well. When it came to dividing the country, the major concern of most citizens was that the currency exchange should not repeat the worst features of the 1953 currency exchange, which was effectively a communist device for stealing the savings of the middle classes. Once fears on that area were allayed, people just listened to the instructions and did what they were asked to do.

Q485 Lord McFall of Alcluith: Could you give us an idea of the mindset of citizens when it came to this change? In your paper, you mentioned about five major regime changes. The mindset in the UK—the citizens of Scotland and England—is set and has been set and the constitution is stable. Is there anything we should learn from the mindset of citizens in Czechoslovakia that it was an easy transition because of the turbulence that had been going on before—anything was better than what happened in the past?

Dr Karen Henderson: It was partly that, but of course a lot of Czechs and Slovaks were very upset by the split. Although the Czech elite pushed it through because they believed that it would be economically advantageous for them, a lot of Czechs did not want the division. They were very attached to their state because it was the best one they had ever lived in of all their historical experience. Slovak opinion was much more divided. One of the advantages of Slovak independence has been that some of the deep-seated divides in Slovak politics and society have been articulated and played out instead of them blaming other people for that.

Lord McFall of Alcluith: Did you see any demonstrations?

Dr Karen Henderson: Yes there were some demonstrations, but civil society generally was not quite sure how to organise itself. Some politicians were fairly skilful in trying to hold up the passage of legislation, including one resolution going through in the federal parliament when a large number of deputies had left the Chamber, that a union of states should be set up between the Czechs and Slovaks to last until EU accession, but again, they could not push that through further. So people did demonstrate, but as autumn progressed, there was a sense of helplessness among the public. Towards the end, they tended to say not that they supported division although some Czechs did; Czech public opinion was much more volatile than Slovak because the issue mattered to them less. People just said that it was inevitable that it would happen and that there was nothing they could do about it.

Lord McFall of Alcluith: So that was a mindset left over from the communist period?

Dr Karen Henderson: It may have been from the communist period or even earlier. This is national stereotyping, but the Czechs tended not to take a conflicting or confrontational means of opposition, but to try to undermine things that they did not like quietly and perhaps in a more concealed manner. It was not just the communist period: there was a sense that they were a small nation and there was not much that they could do about it.

Q486 Baroness Kingsmill: In 1992-93, I was advising the telecom industry in Czechoslovakia on the consequences of the economic arrangements that were taking place. I recall quite turbulent discussions and times that we had. Was there a lot of that sort of thing going on? I was focused on my clients’ interests, but was there difficulty in splitting the different parts of public service, for example, that were common to both?

Dr Karen Henderson: The major problems tended to be some banking assets. Czechoslovak television and radio were not actually problematic to divide, but controversial. The Slovaks frequently argued that they were entitled to financial compensation because the
Czechs had more federal assets. There were some problems in dividing the army because it was located in such a way as to defend Soviet interests that were no longer existent—most of the bases were in the Czech Republic and the entire air defence system was there. But generally, the disruption of dividing the state merges more into the disruption caused by privatisation in general and the major governmental decisions that had to be made on that ground. The Czechs pushed ahead quite rapidly with the second round of voucher privatisation whereas the Slovaks did not.

**Baroness Kingsmill:** So things like transport, telecoms—what else?

**Dr Karen Henderson:** Transport was fairly unproblematic. They stopped running the overnight train that always ran between Prague and Bratislava, because they did not have the federal bureaucrats going up and down anymore and Slovaks did not need to go to Prague to get things done in the way that they had in the past. But generally everything carried on functioning extremely well. The bureaucratic process was quite smooth.

**Q487 The Chairman:** Could you say a little more about the division of property and other assets? You say in your paper that the general principle was that property should belong to the republic in which it was located and that other assets were divided 2:1 in favour of the Czech Republic in line with the size of the two republics’ populations. If that is the general principle, it would nevertheless have been complicated to sort out in practice. Could you say a little more about that?

**Dr Karen Henderson:** I think they reckoned about 95% of issues fell under those two headings. The issues that were problematic were things such as gold reserves. The Slovaks long complained that they actually could not resolve issues because the Czechoslovak bank had not given them the information that they needed. There were arguments about various debts and who owed what. There were complaints about what should be done about Slovaks who had not paid taxes into the federal coffers towards the end of the existence of the common state. There were arguments about foreign trade organisations, about Čedok and who owned the label and about the aeroplanes that belonged to Czechoslovak Airlines. There were lots of arguments such as that and a lot of them were not resolved by the end of the year. But the actual laws that were passed to divide the state were relatively concise and compact, particularly if you compared them with the massive documentation that accompanied the unification of Germany. The law on the division of federal assets fitted on to one page of a tabloid-sized newspaper and the social security law was a bit longer, as was the actual law on the dissolution of the federation. So really they were putting framework agreements in place and then discussing other issues later.

**Q488 Lord Forsyth of Drumlean:** I thought your paper was very helpful. It all seems so easy, particularly the bit that I would like to ask you about, which was the dissolving of the monetary union. In your paper you say that the Slovak currency was devalued by 10%. I thought, my goodness, that must mean that prices went up and people’s savings and pensions were affected. Because of the former history, was it less dramatic in terms of its impact than one might expect?

**Dr Karen Henderson:** Yes, but to repeat the point, post-communist transformation meant that people were used to quite radical changes. Far more traumatic in Slovakia was that unemployment went up from about nil to more than 14% in three years. A lot of Slovak towns were entirely dependent on an arms industry built up in the communist period. It had industrialised on the communist model of industrial monocultures. Therefore, when arms production stopped, you had communities hit by massive unemployment. Prices changed...
enormously. For example, the formal exchange rate of the pound went up from 15 to 50, which had actually been the black market rate before, so people were used to changes—10% devaluation was not really that astonishing a change. There had been quite substantial changes in certain food prices in the two years following the fall of the communist regime, so people did not react as much.

Lord Forsyth of Drumlean: So the fact that they had been part of a command economy where private property was limited meant that an elite doing this without any referendum was easier to achieve than it would be in the UK?

Dr Karen Henderson: Yes. I tend to argue that the UK negotiations would be much more complicated simply because there are far more articulate economic elites in this country—people are able to calculate the economic effects of certain changes. This country has national political parties with decades of experience which are opposed to dividing the state. Structurally, Czechs and Slovaks were less able to oppose what happened. Also, within the business community, even though it was a very different entity from what we understand by “business community”, there was considerable support for division simply because it would enable economic reform to progress rather than having an awkward gridlock. A lot of businesspeople were having to operate with unclear legal frameworks, tax frameworks et cetera, so clarity and rapid change were welcome to some people, even Slovak businesspeople. People talked of the Slovak economy being hit by a catastrophe scenario, but in fact, some of the small new businesses in Slovakia looked forward to being able to deal with foreign companies without having to go through Prague. There were some people who, even if emotionally they did not want the state to divide, could see advantages to it.

Lord Forsyth of Drumlean: So putting it very crudely, would you say that what happened here was that the more successful dynamo spun off what was perceived to be a less successful part, and they benefited, although the experience initially was painful because they ended up with a more competitive position?

Dr Karen Henderson: Yes, though I do not like to overstate the case that the Czechs wanted to get rid of Slovakia for economic gain.

Lord Forsyth of Drumlean: But that was the outcome?

Dr Karen Henderson: Yes, though in some respects the Slovaks have done better in second-generation economic reforms than the Czechs. Some of the innovative ideas they have pushed through have helped them. What was little understood in late 1992 was the extent to which it was the Czechs driving the process rather than the Slovaks. Everybody thought that it was the Slovaks who wanted independence but in fact some of the property division arguments were simply Slovak elite attempts to break the process. Nowadays, very few people would say that what was done was a mistake, even though at the time it seemed a very undemocratic way of going about things.

Q489 Lord Shipley: Could I ask about growth, because you referred to Slovakia doing better than people had thought that it might? Looking at it over the 20 years since separation, has growth been higher as a consequence of there being two countries than had there been only one?

Dr Karen Henderson: It certainly was higher simply because the amount of time they would have spent arguing with each other had they remained in the same state would have paralysed everything. I think GDP growth over 20 years was 60% in Slovakia compared with 35% in the Czech Republic. But that is partly because Slovakia suffered more with the radical effects of the collapse of the communist system, and countries that are less modern and less
developed can modernise and advance quicker. But there were some things that Slovakia was able to do. I do not think that if it had been part of Czechoslovakia it would have ended up in the position of having the highest per capita production of cars in the world. Possibly the obsession of successive Governments with building motorways in Slovakia would have been less had it not been an independent state, but probably growth was higher in both states because of independence.

Q490  Lord Lipsey: My question follows that. As we look at things do we see a big contrast between Scotland and this situation? In this situation, there was a political crisis, legislative deadlock and serious problems for companies as a result, and probably serious problems for individuals as a result. It had to be resolved one way or the other. There is not really any parallel with the Scottish situation because people can argue one way or the other, but there is no crisis. Legislation passed by this Parliament is observed in Scotland and that passed by the Scottish Parliament is observed in Scotland. There is no crisis that would give a bound to growth when it is resolved, whereas in Czechoslovakia there was.

Dr Karen Henderson: Certainly the speed with which division happened in Czechoslovakia was because the division was going to happen and the people sitting on commissions had to sort it out. If you look at other levels, you can see more parallels in both the political and economic feelings in Scotland. Slovaks wanted greater international visibility. They were very irritated by the international tendency for people to abbreviate Czechoslovak as Czech because for a Slovak to be called Czech is exactly the same as a Scot being called English. To that extent, there was a feeling that they wanted more sovereignty. They wanted a greater voice for themselves. It is also interesting economically. People made much of the fact that in public opinion polls the Slovaks appeared to be slightly more left wing. They were keener for slower post-communist economic reform than Czechs. But in fact there was only one question where Czechs and Slovaks always had diametrically opposed views and that was the question of who was subsidising whom. The Czechs knew that they were making transfers from one side to the other, so to them it was clear, but the Slovaks actually felt that they were subsidising the Czechs because their raw materials or semi-finished goods were going to the Czech Republic and then being counted as Czech rather than Slovak exports. Every time I hear a discussion on Scottish oil, I think of that aspect of the Czechoslovak situation.

Q491  Lord Lawson of Blaby: Václav Klaus is a good friend of mine, so I have only his side of the story, which is that Mečiar and the Slovaks complained all the time that they were getting a raw deal from Prague. They thought that they were the poorer part of the federation and needed more help and so forth. They hinted very strongly that if they did not get a better deal from Prague, they would have to go independent and hive off altogether. That was all that they wanted: a better deal from Prague. They were not at that time looking for independence—this is his story. He decided to call their bluff and said, “Okay, if you are not satisfied with the deal you’re getting, which I think is a very good deal, then go your own way”, and that is what happened. Do you recognise that account?

Dr Karen Henderson: Yes, to an extent. I know that on the 20th anniversary, President Klaus put the view that actually Mečiar was quite moderate compared with the rest of the Slovak elite and there were far more extreme nationalists. In particular, he disliked the idea of them wanting to be a subject in international law and then to put together a union of two subjects in international law that would function as a country. It was quite complex. There is also the aspect that the reason he pushed for independence that was that—

Lord Lawson of Blaby: He being who?
**Dr Karen Henderson:** He being Klaus. It was simply that his passion was economic reform. He could not advance with the sort of constitutional structure that Czechoslovakia had.

**Lord Lawson of Blaby:** In his account, he was not actually pushing for independence: he was quite content to have it. But because he was an economist interested in economic reform, he was not prepared to damage the Czech Republic by giving greater economic concessions. So there is a parallel in a way.

**Lord Forsyth of Drumlean:** Except in this case the Scots are pressing to leave rather than the other way round.

**Baroness Kingsmill:** Could you elaborate on the parallel?

**Lord Lawson of Blaby:** The parallel is that Slovakia was asking for a better deal from the union, if you like. The leverage that the Slovaks thought they could use was to say, “If we don’t get a better deal, we will go independent”. Actually, what they really wanted was a better deal, and their bluff was called.

**Lord Forsyth of Drumlean:** Except that no one in the Government in England wants to kick out Scotland.

**Lord Lawson of Blaby:** That is right.

**Dr Karen Henderson:** When it comes to negotiations, that is what will hold it up. To an extent, nowadays it is accepted that the Czech side outsmarted the Slovak side. Once you run an election campaign saying that you are going to increase Slovak autonomy in terms of having a co federal arrangement, a currency and a defence union rather than the existing federation, you cannot really agree suddenly to the status quo if you are being offered independence. What happened later in the year was that Mečiar tried to slow things down by making fairly unreasonable Slovak demands for the division of federal property. At that point, Václav Klaus threatened that the Czech Republic would go independent. But that could have been very problematic, because that would have left Slovakia as the successor state, whereas the arrangement that was made left two successor states with equal rights.

**Q492 Lord Rowe-Beddoe:** I was interested in your references to devo-max. I do not quite understand its meaning but it is a phrase that is currently being used. I read your paper and it was a very interesting comment that you make. I hope that I am not putting words into your mouth, but you said that devo-max might work in the United Kingdom because of the asymmetrical political settlements that already exist. However, you said to beware of devo-max. Could you expand on that?

**Dr Karen Henderson:** Confederation was also a very hazy concept and the Czech side said, “We do not know what you mean by this: this looks like two independent states”. Confederation was viewed by the Czechs as Slovaks wanting to have their cake and eat it. It meant everything favourable to the Slovaks whereas the Czechs saw it differently. One of the expressions used was that the Slovaks wanted independence with a Czech insurance policy or they wanted to prepare for independence gradually at the expense of the Czech taxpayer and issues such as that. The problem is that when you have an undefined or third option, people are not sure what is being negotiated. Also, at what point will those on the Westminster side feel that agreements might not be acceptable to their own voters? I do not know; that is speculation. I think there is perhaps a concern on my part, which is over influenced by the Czech and Slovak case, that the larger entity may suddenly decide that it has had enough. The Czechs were visibly getting very bored with having to discuss federal arrangement for two years. If it goes on long enough, one wonders what the English mood will be. The English are less sensitive than the Czechs. The Czechs were quite upset by the
idea of the Slovaks portraying them as some kind of oppressive, big power because the Czechs regarded themselves as one of history's small victims. To be pushed into that role was so strange to them that they could not take the Slovak argument seriously. Certainly, unclear options do not help rapid decision-making, but rapid decision-making is not necessarily needed in this case.

Lord Tugendhat: My question is really about individuals and I will bundle some together. After the break, were there many people who felt the need to move from one successor state to another? How many people who lived in Slovakia felt that they were Czech and needed to move and vice versa? Linked to that, was there a great deal of intermarriage? In the case of Yugoslavia, despite all the terrible things that happened there, lots of Croats were married to Serbs and lots of Slovenes were married to Croatians. That did not stop them doing dreadful things, but there was a lot of intermarriage. If you had a person who regarded himself as Slovak married to a woman who regarded herself as Czech, was there any sort of formality about which you decided to be? Linked to that, I have a question about the bureaucracy. If you are Northern Irish, you can choose pretty much if you want to join the Irish Civil Service or the British Civil Service if you want to become a civil servant. You can become the Irish ambassador to somewhere or the British ambassador to somewhere. In the case of the Czechoslovak bureaucracy, there must have been some career assessments about where one had the best chance of making rapid progress. Did that lead to a diversion of talent from one to another? I am afraid I bundle several questions together, but they are all about human beings.

Dr Karen Henderson: There was quite a lot of intermarriage. Václav Klaus could maintain not to be hostile to Slovaks on the grounds that he was married to one. For instance, it was a problem with the diplomatic service for the Slovaks and with army officers.

Lord Tugendhat: With what?

Dr Karen Henderson: With army officers, because four-fifths of the army was based in the Czech Republic. Although Slovaks were fairly represented among the officer class, a lot of Slovak officers had Czech wives and effectively Czech children. They had Czech homes. In a country that does not yet have a housing market, moving is not much fun, even though the new Slovak army was planning to get accommodation for officers. In that circumstance, a lot of people chose to remain in the Czech Republic simply because it was where they lived. To uproot a partner and children to a country where they did not know anyone and where housing might not work out was difficult. In terms of nationality, it was interesting because originally the Czech proposal had been that the Czech Republic and Slovakia should be like any two foreign countries and that you would need work permits and that sort of thing. In fact, free movement of labour was established along with the customs union. One difference was that the Czechs banned dual citizenship whereas the Slovaks did not (they have since for completely different reasons). So if you were to continue your career in the Czech Republic, you had to take up Czech citizenship. In fact the federal prime minister, who was given the job because he was a Slovak, later became a Czech citizen because he was simply Prague-based. Those in the Czech Republic did have to decide on citizenship.

Lord Tugendhat: So you became a Czech or a Slovak because that is what you decided, regardless of what you actually were? You decided, “I've got a better deal being Czech so I will be Czech” or “I've got a better deal being Slovak”. It was un choix, as it were?

Dr Karen Henderson: Not entirely. The first wodge of international criticism that the Czechs encountered was that they put in a stipulation that you had to have a clean criminal record for five years if you were of Slovak nationality. Of course, nationality was just
something that had been written in your documents of no significance up until then. If you happened to have Slovak nationality in your documents and had been living in the Czech Republic for decades, if you had committed a criminal offence you could not get Czech citizenship. That was generally considered to be a method of getting rid of the Slovak Roma, who had been compulsorily settled in the borderlands.

Lord Tugendhat: Whereas here, unless somebody corrects me, I cannot think of any official document in which one is obliged to state that one is Welsh, English or Scottish.

Dr Karen Henderson: It was exactly the same in Yugoslavia. Your nationality was put down and people got very confused when they came to the United Kingdom and were asked their nationality. They frequently put down their nationality when the British were really asking them about their citizenship. It is a confusion of terms.

Q494 Baroness Kingsmill: Can you hear or see the difference between a Czech and a Slovak?

Dr Karen Henderson: Yes, if they are speaking Slovak, you know that they are Slovak.

Baroness Kingsmill: So a Czech would know that this was a Slovak.

Dr Karen Henderson: Even if they were speaking Czech, they would probably have a Slovak accent. I have a Slovak accent in my Czech. They said that I was the only person they had ever met who spoke Czechoslovak.

Baroness Kingsmill: You can tell.

Dr Karen Henderson: It depends. A lot of Slovaks who lived in the Czech Republic for a long time spoke fluent Czech. They are different languages; they are just mutually intelligible. The television news had a different-language anchorperson every week, but if a Slovak visited Prague they would be interviewed by a Czech reporter who would ask questions in Czech which were replied to in Slovak. The only thing they did not confuse on television was that Slovak television showed only Slovak children’s programmes and Czech television was the same. They wanted the children to get the two languages distinct and then the adults mixed them up.

Q495 Lord Hollick: I want to come back to Lord Rowe-Beddoe’s question. I inferred from your warning about devo-max and independence-lite that this was a slippery slope and that if we go down that slope and concede more independence and more devolution, you might say, the demand for ever greater devolution might be increased. I want to link that to another point that you referred to earlier. A key judgment here is, “Will I be better off in an independent regime or if I remain part of the union?” which I would have thought is one of the key considerations of interest to voters in the referendum. There is a sort of “Can I have my cake and eat it?”—let us call it devo-max—“and still retain all the benefits of being part of the union, which may be generous Barnett formula, lots of employment thanks to the MoD, et cetera?”. Do you see my point?

Dr Karen Henderson: I think it was a particularly sensitive issue in Czechoslovakia because a lot of the redistribution was going on in the post-communist period. Minorities there were very keen that they did not get a fast one pulled on them and lose access to resources. There was certainly a degree of mistrust that somebody might be getting resources that were really yours. I think it is partly an issue of size in the Czech and Slovak case, because both entities were a substantial size. I am just not sure in the UK/Scottish case, partly because it is not an area that I am specialist in, to what extent public opinion will turn on
economic issues. What is important is that political elites can do a lot to steer public opinion if they try. In Czechoslovakia, quite simply they did not try. The Czech Government were keen on pushing independence and the Slovak Government had exploited nationalism in a fairly intemperate manner on occasions. The situation was probably far more dramatic in that respect in Czechoslovakia. It is the insecurity of post-communist transition. There is a mood in this country at the moment, I suppose, of “We don’t want people getting something for nothing”.

Q496 Lord Forsyth of Drumlean: Lord Hollick has picked up the point I was going to ask about. You are talking about what happened in Czechoslovakia. It is very interesting, but I have been looking at this purely from the point of, “What are the lessons that one can draw from this experience?” As I was listening to you, the thought formed in my brain and clearly that of Lord Hollick as well that, my goodness, there is a way of achieving independence without a referendum by going down the devo-max route to such an extent that the people who are paying the bills who do not actually feel particularly strongly one way or the other suddenly decide, “Up with this we will no longer put”. The force that breaks the union could come from the opposite side of the divide. This is not a political Committee but, I am thinking, actually, if I am Alex Salmond and I want an independent Scotland but I do not want a referendum because I would almost certainly lose a referendum, a smarter tactic would be to get my opponents to agree to devo-max and then I act on things such as tuition fees or whatever. There may be more of a parallel in what has happened in Czechoslovakia from the point of view of how you can break up a union without a referendum than I imagined. That is putting a lot of words into your mouth. While I was listening to you I was filled with alarm because I had never really thought about that in the context. Even having read your paper, I had looked at it from the angle of whether there were lessons here. I had thought that there were not many lessons, but perhaps that is one.

Dr Karen Henderson: The difference is that Westminster can say no, whereas the Czechs could not get all sorts of legislation through if 40% of Slovaks in the Slovak half of the Chamber of Nations were prepared to vote against it. Simply ignoring demands is feasible for the UK.

Lord Forsyth of Drumlean: Yes, but I am making the opposite point. You could concede and Westminster could say, “Actually we should go further down the devo-max road”. I am trying not to put words in your mouth, but the thought occurred to me about a lesson here. If it reaches a point where people—in this case, the Czech side—think that they have been taken for a ride, they actually turn and become proponents of breaking the union. Is that a parallel?

Dr Karen Henderson: Yes, it is possible. To an extent, if the idea that Scotland would have to reapply for EU membership becomes widely accepted, then the logic of just pushing for devo-max becomes very strong.

Lord Forsyth of Drumlean: From which point of view?

Dr Karen Henderson: Being as near as you could be to an independent state without having to join the euro would be a fairly attractive option, as opposed to being pushed into joining the euro.

Q497 The Chairman: Could I ask a bit more about defence, and in particular how defence issues were resolved? There is a great issue on the horizon as far as defence is concerned in terms of Scottish independence as to what happens to the nuclear fleet and all
That sort of thing and the huge assets that they are there. Were there any parallels in the Czechoslovak situation?

**Dr Karen Henderson:** Not really. I think the UK case is much more difficult, simply because the UK is far more of a military force. Czechoslovakia was not used to the idea of having an army to defend itself. The Czechoslovak army by and large did not fight—at least not on Czechoslovak territory. There was considerable confusion about what the army was for, particularly when it came to be the air defence system. As people said, you cannot divide an air defence system in two because it will not work. As far as I recall, there were some Slovak objections to the air defence system having been given to the Czechs because they did not have one, and supposing the Czechs attacked Slovakia? At that point, some people said, “This is ridiculous”. There was an issue in the Czechoslovak case because they did not know who the enemy was, because the Soviet troops had gone. Russia, at that point, was pretty well at its weakest, so people were not thinking of the Soviet threat and they are not quite sure what they need an army for. Later on, they planned to join NATO anyway. I think they were not countries that felt an urgent need to have a defence force. Obviously, some people did.

**Q498 The Chairman:** On a different tack, one or two of our witnesses have suggested that an independent Scotland would see a resurgence of entrepreneurial activity and enterprise. Was there any parallel to that in the Czechoslovak case, particularly in relation to the Slovaks?

**Dr Karen Henderson:** It is quite hard to say because there is an upsurge in entrepreneurial activity anyway when you take away communism and allow people to set up companies. Independence was helpful to Scottish entrepreneurs because foreign companies tended to regard Czechoslovakia as a single country.

**Lord Lawson of Blaby:** To who?

**Dr Karen Henderson:** Therefore they always dealt via Prague.

**The Chairman:** I think you said Scottish, but you meant Slovak.

**Dr Karen Henderson:** Sorry.

**Q499 Lord Tugendhat:** Division took place in the immediate aftermath of the end of communism, so if you were an ordinary citizen living in the Czech Republic, Slovakia, Hungary or Poland, let us say, taking those four countries, so far as the Czechs and Slovaks were concerned do you think that the biggest change was the break-up of Czechoslovakia or the end of communism? Would a Slovak living in Slovakia feel that his or her life had changed more than that of a Pole or a Hungarian, or would the end of communism be the principal change from now as against then?

**Dr Karen Henderson:** The end of communism.

**Lord Tugendhat:** The end of communism?

**Dr Karen Henderson:** Yes, because some of the economic disruption caused to people by the end of communism and the negative effects of the end of communism as well as the positive effects were greater than the negative effects from the division of the state.

**Lord Tugendhat:** So this was, in a sense, although it looks important from the outside from the point of people’s ordinary lives, a subordinate change to the end of communism?

**Dr Karen Henderson:** Yes.
The Chairman: Any other questions? This has been a very interesting session, Dr Henderson. Thank you for sharing your knowledge with us.
TUESDAY 3 JULY 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Currie of Marylebone
Lord Forsyth of Drumlean
Lord Hollick
Baroness Kingsmill
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Smith of Clifton

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Examination of Witness

Professor Gerald Holtham, Chairman, Independent Commission on Funding and Finance for Wales.

Q331 The Chairman: Welcome. My apologies for the slight delay but we have had a few matters to discuss. I fear that there may be a vote half way through our hearing, so we will disappear for 10 minutes and then come back.

Professor Holtham: Not at all. I am at your disposal.

The Chairman: Thank you very much for coming. We are very grateful because we want to look at the effect of the possibility of an independent Scotland on Wales, which I know you have written on and thought about a good deal.

Perhaps I may start with a very general question, which will enable you to set the scene. What do you see as the economic implications for Wales of an independent Scotland?
**Professor Holtham:** The immediate macro-economic implications are quite small. It obviously depends on what assumptions you make about the nature of Scottish independence, but it seems that the best guess we can make at the moment is that Scotland would wish to remain in the EU so the single market would persist, freedom of movement of workers would persist and freedom of movement of capital would persist. Indeed, it seems very likely that Scotland would adopt the pound as the currency. That could take different forms and it could either be a currency board or a full currency union.

When you boil all that down, an awful lot of things will remain the same. There is of course the possibility of tax competition, but I wonder how far that will operate. If Scotland wishes to join the European Union, I do not think that the EU would be very gruntled at the thought of Scotland trying to adopt Irish corporation tax rates, for example. There may even be limits then on the extent of tax competition. I am sure that lots of minor things would accumulate over time to make a considerable difference but the immediate macro-economic impact would probably be surprisingly small. It could look a bit like Czechoslovakia.

**Q332 The Chairman:** We will come to the tax implications in more detail in a moment. There are not many strong linkages between Scotland and Wales as such, in the same sense as the north-east and others are heavily affected by anything that a Scottish independent government might do.

**Professor Holtham:** A surprising number of senior civil servants in Wales seem to be Scottish. One of the directors-general of the Civil Service is Scottish, as is the director of transport. I am a shareholder in Welsh whisky and our leading consultant is Scottish, as you might expect. There are lots of personal linkages certainly. But you are right. Of course, there are no trade statistics to demonstrate that because we are all in one country, but I do not get the impression that there are many industries where the value chains are very closely linked.

**Q333 Lord Lawson of Blaby:** The question that the Lord Chairman asked was about the implications of Scottish independence. Since it is in our remit, would you give the same answer if he had asked you about the implications of Scottish devo-max, whatever that may mean? Would there be a cry for Welsh devo-max as well and what would that mean?

**Professor Holtham:** There may be an implication there. Devo-max, as such, would mean the end of a block grant for Scotland. There are various other schemes going around about a “devo more” or a “devo a bit more” in which some sort of block grant persists. That will raise the question of how that block grant should be calculated, which is a very live issue in Wales.

I do not think that Wales could or should be tempted to follow devo-max. There is a huge economic difference between Scotland and Wales; namely, that if Scotland gets North Sea oil tax revenues, and the oil price is reasonably high, it is not very far from having the same size deficit as the UK as a whole. In other words, there is no large net transfer from or to Scotland in that situation.

That is not the case in Wales. The public deficit in Wales is roughly 25% of Welsh GVA. Wales cannot afford devo-max. It will have to receive a large transfer for the foreseeable future.

**Q334 Lord Currie of Marylebone:** I should like to explore with you the Barnett formula, which your commission commented on and you have just started to touch on. With Scottish independence, would you expect changes to the Barnett formula in the rest of
the United Kingdom, including Wales? If something slightly short of devo-max emerged with the continuing grant allocation to Scotland, how would that be formulated and what, again, would the implications be for Wales?

**Professor Holtham:** If Scotland were independent, there is a school of thought that says that would remove the primary obstacle to a reform of the Barnett formula. One of the things our commission showed was that if you simply took the distribution formula that is used in England to distribute health expenditures, what used to be applied in education and that applied for local authority support grants around the English regions, and applied those formulae in Wales and Scotland, as demonstrating current distributional judgments, you would find that Wales is very slightly underfunded—I would not exaggerate it—at about 2% or 3% and Scotland is overfunded by about 15%. On the basis of relative need, if that is the criterion you adopt, Scotland gets too much money. Therefore, it is very hard to reform Barnett if you trying to persuade the Scots that they should remain within the United Kingdom. No UK Government of any political persuasion in the past five years has shown any appetite for taking that on at all. There is a theory that says that if the Scots are out of the way, we could have a reform. I must say that I do not believe it. I think you get what you can negotiate. On the whole, the Welsh have no cards, so they will get what they have always got, which is nothing.

**Lord Currie of Marylebone:** Not quite nothing.

**Professor Holtham:** Well, not quite nothing. They get a fairly large transfer, in fact. But they will not get any more.

The commission that I sat on was aware of this problem. We thought about whether there was something we could do which does not upset the Scottish wasp-nest, as it were. Of course, one of the features of the Barnett formula is that if public expenditure is growing, it will result in the expenditure in the devolved territory growing slightly more slowly than in England. So there is a convergence process, a squeeze. We thought that has justification as long as the devolved territory is getting more than it would if it were part of England. Once that ceases to be true, surely there is no further justification for a continued convergence. So why do we not just have a rule that says when you hit the floor you stop converging? We thought that that would be fairly non-toxic because it would not affect the Scots—they are not on the floor but on the ceiling. No British Government have shown the least interest in conceding that to Wales—not at all. That tells me that strict logic has nothing to do with it; it is what you can negotiate. I do not know that the Welsh bargaining position would be improved by Scottish independence, so I would not bet on reform.

**The Chairman:** We have a number of experts on this Committee on the Barnett formula who formed a separate Select Committee, as you may know.

**Q335 Lord Forsyth of Drumlean:** Is your approach not a bit cynical? Surely, people in Scotland, as well as in Wales and England, would expect the funding to be based on fair principles. The fact is that in Scotland the extra money is being used, for example, to provide free prescription charges, free care for the elderly and free tuition fees and so on. Therefore, is the argument saying that reform will not happen—because it adds to the possibility of Scotland, which you have just used, leaving the United Kingdom—not the other way around? If people perceive unfairness in the distribution of money, that causes resentment and pressure on the other side of the border.

**Professor Holtham:** I do not think that that is so because there is more than one criterion of fairness. If you accept that you are in a union and that all taxes are in some sense put in a
central pot and distributed strictly according to relative need, which was the position that the report that I chaired adopted, you can argue that Wales is underfunded and Scotland is overfunded. But that is not the only way to look at it. If you take a more explicitly federal view, you might think that the origin of taxes has something to do with where expenditures take place. If you switch the focus from relative need to the size of the net transfer between regions of the federation, the Scots do not receive a very large transfer—at least not when the oil price is high. The Welsh do receive a large transfer. So there are different frameworks within which to look at this. I do not have any doubt that if Scotland is not there, the UK will find a framework that suits the centre best. I do not think that that is cynical; I think that it is simply realistic.

Q336 Lord Forsyth of Drumlean: But if the money is then distributed, as it is in Scotland, by the Scottish Parliament and previously by the Scottish Secretary on the basis of formulae which are based on need, is that not a contradiction?

Professor Holtham: No, the contradiction is that there is a block grant, which is not based on need. Once they receive the block grant, yes, they do as the English do and, indeed, as the Welsh do. They distribute the money within Scotland on the basis of formulae. In fact, the commission I chaired took the Scottish formulae and combined them with the English and Welsh formulae to get a kind of UK weighted-average formula to see what the Barnett allocation should look like. The point is that the Barnett allocation is in that sense anomalous, in that distributional decisions within England, within Scotland and within Wales are all made on the basis of distributional judgments embodied in rather complicated formulae; the Barnett allocation itself is not so determined.

Q337 Lord Smith of Clifton: How would you compare the economic structures of Scotland and the rest of the UK? What are the similarities and differences? Are there any parallels with comparisons between Wales and the rest of the UK? If Scotland were to become independent, how would you expect these structures to change over time?

Professor Holtham: Both Scotland and Wales are somewhat more dependent on manufacturing still than England—that is averaging and generalising for England—which is why they both run rather small surpluses on goods trade, for example, whereas the UK as a whole runs a rather large goods deficit. The Scottish economy is much more diversified and in better shape than the Welsh economy. Scotland of course has North Sea oil, which would constitute a substantial part of its tax revenue if it were independent. It would be quite difficult to manage because those revenues would be very volatile, depending on the oil price—that would be a difficulty for them. Apart from that, Scotland has a reasonably substantial financial sector, which Wales lacks. The structure of industry is not dissimilar with lots of transport equipment and light manufacturing.

How would the structure change? As I have said, as there would be rather little change to the institutional environment, any change would be quite gradual. I do not have a theory that says that there would be a very rapid change in structure, because it would depend on the policies that Scotland adopted.

Q338 Lord Rowe-Beddoe: I should like to talk about inward investment. Could you give us some reasons as to why Scotland has been performing so well in direct inward investment over the past five or six years by comparison to Wales?

Professor Holtham: I am probably a little better informed on why Wales has done relatively poorly than I am on why Scotland has done relatively well. I know that the Scottish Government have been quite energetic. This is all anecdotal but there are quite a lot of
anecdotes to suggest that they are quite active in contacting businesses, talking to them and offering them good terms and things of that sort. I do not think that the Welsh Government have been anything like as active as that. It has also got something to do with the structure of industry. As you will know better than anyone, Wales was very successful in attracting foreign direct investment in the 1980s particularly. I think that that was largely based on the fact that Wales was a very low wage area of the EU and we were able to attract a lot of assembly and manufacturing business, which was looking at the European market. Wales was therefore particularly badly hit by the enlargement of the EU and the entry of eastern European countries, whose populations were possibly better educated but were certainly cheaper. There was quite a historic shift. You had a period of investment in manufacturing following the decline of the heavy industries in the 1980s. A lot of that manufacturing promptly disappeared in the late 1990s and noughties, leaving the economy in a somewhat fragile state.

Q339 Lord Rowe-Beddoe: I would suggest that the level of wages in the 1980s in Scotland was not that different to the levels in Wales, so there has to be a little bit of something else.

Professor Holtham: I think Wales of course had a very prominent development agency, of which you were chair for a while, which acquired a sort of brand in the market and was quite well known. Certainly, I have had anecdotes from people in England saying that they wished that they had a similar institution. In a sense, that played perhaps the role that the Scottish Government have played more recently of actively looking for investment opportunities and trying to bring people in. I do not think that many people in Wales regard the assimilation of the Welsh Development Agency into the Civil Service as a success. By everyone except the Welsh Government it is regarded as probably a mistake.

Q340 Lord Rowe-Beddoe: Although Scotland of course still has a separated agency in that sense, England has now had them all removed under the Act of last year. Is it just the focus? What would happen if Scotland were to become independent? I will put it another way. An important advantage of investing in Wales was that a business would come into the United Kingdom in order to be based in the European Union. That is what was sold. That was the story of Wales. It was not the story of “Come to Wales”. In fact, our people used to say, “Invest in the United Kingdom”. First, you wanted to get their interest in that. Of course Scotland and Wales competed very strongly in the 1980s and 1990s. The Scots would say, “Come to the United Kingdom” and then we have a wonderful place for you to go within the United Kingdom. Suppose, we now have a separation. Will that affect its inward investment on the assumption that there is no tax differentiation and that it does not do a Republic of Ireland because it is not allowed to? But it would not be part of the United Kingdom as such. Assuming Scotland stays in the European Union, would you expect its performance to be the same?

Professor Holtham: I would not have thought that there would be a great change. Scotland has a high degree of international recognition in a way that Wales does not. Holywood has made “Braveheart”; it has not made Owain Glyndŵr. It did not even notice that William Wallace must have descended from Welsh ancestors—that is what his name means. You have got whisky and golf. All Americans know about Scotland just as they know about Ireland; despite Catherine Zeta-Jones, they do not really know about Wales. I do not think that Scotland would have an image or a branding problem. It is an old country and people are familiar with it, especially those areas which are exporting capital. I would have thought that it could carry that off.
Q341 Lord Lipsey: We hear a lot, particularly from proponents of Scottish independence, that once it is an independent country the animal spirits of Scottish entrepreneurs will be let loose and miraculously the growth rate will greatly accelerate. We have had some echoes of those arguments from Wales. There was a recent-ish research project that I vaguely remember, which said that, if ever it was independent from Britain, Wales would automatically and immediately move to the sort of growth rates in some of the EU’s faster-growing regions. Do you as an economist think that there is any substance in those arguments? Do you believe that the claims made particularly for Wales have any validity?

Professor Holtham: They are highly conjectural arguments. I do not think that it is possible to say definitively that it is impossible. It could happen but it is extraordinarily difficult to forecast what it would be worth quantitatively. I get the impression that in Scotland there is quite a strong esprit de corps already and quite a strong feeling for the country in that there are possibilities there. I am just not sure how far that would be catalysed by independence to be even more the case. I cannot exclude it.

In the Welsh case, I do not think that there is enormous confidence in Wales and the Welsh Government’s ability to set a framework that would make a substantial difference. An awful lot there would depend on policy.

Q342 Lord Hollick: Can I come to the supply of labour, particularly through immigration. The SNP has indicated that it would take a more relaxed view in terms of immigration. What is your assessment of that? Do you think that that would be to the detriment of the rest of the United Kingdom? I do not know whether you looked at this in your report but would Wales take a different view? Given the contiguous borders, how would the leakage of immigrants be prevented?

Professor Holtham: I think that the Scots would have an opportunity to take a more relaxed view about graduate students. That is one area where people have become quite concerned about the nature of immigration policy. If they were in the EU, they have to take the same view of EU immigration as the rest of the UK. So it would come down to extra EU migration and I would guess that they would mainly focus perhaps on the academic area as one where they could be rather more relaxed and perhaps gain an advantage for their universities over the rest of the UK. Wales does not have a separate jurisdiction at the moment and immigration is not devolved anyway. Unless there were a substantial extension of devolved powers in Wales it just would not arise.

Q343 Lord Hollick: If Scotland were to gain independence or devo-max or “devo more”, do you think that there would be pressure on this and other issues in Wales to have more devolved powers so that effectively it would become more competitive?

Professor Holtham: Yes, I think that there would but we revert to the point I made earlier that Wales is going to need for the foreseeable future a substantial block grant. It is difficult to argue for the right to have beggar-my-neighbour policies when your neighbour is paying a substantial part of the bills. Realistically, there will be a slipstream effect—there has been and I think that there will continue to be—but there are limits to that. Wales certainly could not adopt devo-max or anything of that sort.

At the moment a lot of these discussions are taking place on a bilateral basis whereas they really should not be. The UK has been under pressure from Northern Ireland to let it have a lower corporation tax rate because it has a shared border with the Republic, which has a lower one. The SNP is arguing for it in Scotland. It seems to me that you could devolve corporation tax as an instrument of regional policy. You could say, “All right, if you are a
devolved Administration, you have the right to change it according to the Azores judgement. But we cannot have a race to the bottom, so we are going to have a framework”. One of the things that we suggested was, “Just take your deviation from average GDP per head or GVA per head in the UK, and you can cut your corporation tax by an amount that depends on how poor you are”. That would do the Scots no good at all because they are not much poorer than anyone else, but it would help the Welsh and the Northern Irish. But it seems to me that that is what you would have to do. If you are going to allow the devolution of taxes which have a material effect on economic location decisions, you should have an overarching framework and some principle that says how far people can take advantage of that. Otherwise, you just get a race to the bottom or it becomes a nonsense.

Q344 Baroness Kingsmill: It is hard for me at the moment quite to see the relevance of this question to Wales entirely but perhaps you can assist me in that. What currency do you think Scotland would use in the event of it becoming an independent nation? Are there any implications for Wales?

Professor Holtham: Scotland has said that it would stick with the pound. There are two ways of doing that. It could either do as the Baltic states have done, which use the euro but have a currency board. In other words, the currency board would issue Scottish pounds but only to the extent that it had UK pounds as reserves. That means that you are importing your monetary policy from England effectively but you do not have a lender of last resort and, to that extent, your financial institutions may be regarded as more vulnerable and you may have to pay higher interest rates for your debt. To escape that, you could say to the UK, “We wish to remain in a currency union with you. Perhaps we would like to be represented on the Monetary Policy Committee”. But if that were to happen you would certainly have to submit your financial institutions to the regulatory control of the Bank of England. There is no precedent for this in British history that I am aware of, but it may be that the bank would also then say, “Well, look, it is like Europe. We cannot have you running too big a deficit if we are somehow responsible for your monetary stability”. It seems to me that there would be a big trade-off for Scotland between the appearance of independence and a lot of autonomy against the risk of operating a currency board without a lender of last resort. I do not know which way it would want to jump, but I am sure that it would do one of those two things.

Q345 Baroness Kingsmill: Are there any Welsh implications?

Professor Holtham: I suppose that if there is competition for location and it costs more to raise money in Scotland, that might have a very small positive effect on Wales. But it would be second order.

Baroness Kingsmill: I do too.

Q346 Lord Levene of Portsoken: You were talking about tax competition and a race to the bottom. Do you think that if Scotland were to introduce different corporate tax rates or even different personal tax rates, Wales would think, “We have got to jump on the bandwagon as well”? How would you avoid yourself getting into this race to the bottom and getting into something which on the surface would look attractive but in fact was pretty disastrous economically?

Professor Holtham: If Scotland were independent, or even not independent but given bilaterally the power over things such as corporation tax and Wales were not, there would be quite a lot of bleating about that being unfair. It would be of course even more unfair on the north-east of England and the north-west of England, where location decisions would be
more immediately affected. It has implications far beyond Wales. If you look at relative income per head, it is difficult to see a particular justification for Scotland having lower corporation tax rates than other parts of the United Kingdom. Apparently you cannot give them to regions of England because of EU regulations. It would be state aid if you announced that the north-east could have lower corporation tax. Because of the Azores judgement, there is the oddity that if you are fully devolved, you can make your own decisions and you take the implications on your own budget, then you are allowed to operate different tax rates. That is relevant only for the devolved territories. You certainly have to consider the impact on England. As it happens, Bristol is reasonably prosperous, so they could put up with it if Wales had a slightly lower corporation tax rate but I do not know if you could say the same thing for Carlisle.

**Q347 Lord Forsyth of Drumlean:** Do you think that the rest of the UK would have higher or lower borrowing costs if Scotland became independent?

**Professor Holtham:** If Scotland became independent, the rest of the UK would have probably a slightly worse-looking balance of payments. Certain flows that are currently internal—mainly oil, for example—would appear as imports. Scotland runs a small surplus on its trade of about £5 billion, which presumably would disappear from the UK. We would be running ostensibly a larger current account deficit. Would that have any material effect on our borrowing costs? I do not believe that it would. I think that any such effect would be very small.

**Q348 Lord Forsyth of Drumlean:** Do you think an independent Scotland which was issuing its own debt would have higher borrowing costs than the rest of the UK?

**Professor Holtham:** I think that that depends on the nature of the currency union. If it remained in a currency union where the Bank of England was acting as lender of last resort, I do not see why that should happen. If it was operating a currency board without having a lender of last resort, it might well do.

**Q349 Lord Forsyth of Drumlean:** But that would imply then that there would have to be an agreement as to the borrowing limits that Scotland could have.

**Professor Holtham:** It might well imply that. As I was saying earlier, I do not think that there is any precedent. I am not aware, for example, that the Bank of England says anything to the Turks and Caicos Islands about what borrowing they can do. There is no precedent for the Bank of England instructing people who are using sterling as to what they should do. But you are perfectly right that there is that possibility. If it decided that it wanted to do that, it could do it and appeal to the ECB or the European Union as a precedent that a condition for supporting the financial stability of Scottish institutions would be that some restriction on fiscal policy is accepted. That is possible.

**Q350 Lord Forsyth of Drumlean:** You alluded earlier to the importance of the oil revenues to the Scottish budget. Do you think that the volatility of the oil price might make it more expensive and harder for Scotland to borrow money?

**Professor Holtham:** If I had to guess, I would say no but I do not know. The thing is that short-run volatility is not so important. If the markets thought that the Scottish Government were assuming more oil production over the medium and long term than was likely to happen and was running a fiscal policy that was presupposing trend-wise that those revenues were higher than they were likely to be, you could get into trouble. If the Government were following reasonably conservative fiscal policies to take account of that, the fact that revenue
bounces up and down from one year to another would not be a problem. Again, it comes
down to how policy-makers handle it. Volatility of income in itself does not normally lead to
higher borrowing costs in the sovereign.

**Q351 Lord Lawson of Blaby:** Perhaps I may just make a comment, which Professor
Holtham can respond to if he wishes, before I go on to a separate issue. Surely, you have to
look at the fact that this track record of the Scottish Government would be unknown.

**Professor Holtham:** Yes.

**Lord Lawson of Blaby:** And you say that if they pursued a conservative policy, that would
be fine. But, of course, initially the financial markets will have no idea what sort of policy
they are going to pursue. One would think—but if I am wrong, tell me—that there would be
a slight wariness in the financial markets to begin with until a conservative track record, to
use Professor Holtham’s own expression, had been established.

**Lord Lipsey:** Perhaps I may add to that point. In fact, the financial markets will see a
Scotland that has been prepared to spend money in what some would regard as a very
liberal way on social benefits such as no prescription charges—which we also have in Wales
and I benefit from each week—and no paying for personal care or tuition fees. Of course, if
you are prepared to cover that by higher taxation, that is okay but there are not going to be
transfers to cover that. So does Lord Lawson’s point have even greater validity in that the
track record, such as it is, would tend to make markets rather wary of lending to an
independent Scotland?

**Professor Holtham:** I do not know that you can make that argument. Of course, Scotland
has not had the power to borrow so, by definition, it has had to balance its budget. They are
giving free prescription charges but it is doing that by not spending the money on something
else. It is true that its expenditure per head is higher than in the rest of the UK, apart from
London and Northern Ireland, but it has been receiving a block grant to cover that.

**Q352 Lord Lawson of Blaby:** But they will not receive a block grant. If you look at just
the oil revenues, the figures that we have been supplied with suggest that there will be a
resulting deficit, which would be proportionately larger than the deficit for the UK as a
whole.

**Professor Holtham:** That absolutely depends on the price. The deficit was larger for the UK
as a whole in 2007-08. It was smaller than the UK as a whole, I think, in 2008-09 and it is a
little higher again in 2009-10. You may be right but it absolutely depends on the oil price. As
I have said, if you average the oil price in recent years, the Scots, relative to the rest of the
UK, are in very broad balance. I absolutely take the point about the danger of keeping
spending at a rate that assumes the oil price would remain very high indefinitely.

**Q353 Lord Lawson of Blaby:** Pursuing this a little further, we have elicited that there are
two dimensions of uncertainty: namely, uncertainty about the oil price and uncertainty about
the spending policy of an independent Scottish Government. There are double uncertainties,
both of which are quite significant and the financial markets would have to factor in and
assess. We do not know what their assessment would be, but they would have to do that.

**Professor Holtham:** They would, and I do not think that they are independent uncertainties.
As I have said, if the Scottish Government persuaded the market that they were framing
their policies in full awareness of the volatility of their income, the problem is resolved. They
are not independent risks, but I freely agree that that risk exists.
Q354 Lord Lawson of Blaby: They are not independent, but they are not the same either because they could pursue a spending policy irrespective of the oil revenues and so on.

Professor Holtham: Yes.

Q355 Lord Lawson of Blaby: And the oil revenues would do what they do, irrespective of their spending policies. So these are separate factors even though there is a connection between them.

Professor Holtham: I think it would be rather like the policy that the Labour Government followed in 1997. They attempted to follow a very tight policy initially in order to establish some credibility. Having done that, they reversed the policy. But I imagine that the Scots would be well advised to do at least the first part of that.

Q356 Lord Lawson of Blaby: I will ask the question that I was going to ask—sorry, Lord Forsyth’s question was so fascinating that I wanted to take it a little further. Assuming that the United Kingdom retains the independent deterrent—nuclear submarines, Trident or its successor and all that—clearly, the idea of having your independent deterrent based in a foreign country is slightly implausible. The defence experts think that it would be relocated to the United Kingdom and that the destination of choice is Milford Haven, in Wales. It is only just in Wales and is a rather English part of Wales. Nevertheless, it is in Wales. If that were to happen, would that, first, confer an economic benefit on Wales and, if so, would it be of any significance? Secondly, would there be a political uproar in Wales if that were to happen?

Professor Holtham: I am not an expert in this area so I do not know how far this is a real problem and how far it is an apparent problem. But Milford Haven is one of the largest oil and liquid natural gas importing ports in the UK and there are substantial liquid natural gas facilities. On the face of it, it is not an obvious place to put a nuclear deterrent.

Lord Lawson of Blaby: I am talking about a submarine base. That is what we are talking about.

Professor Holtham: Absolutely. But if you are going to be storing nuclear warheads, and you are going to replace Faslane and store nuclear warheads in the vicinity, there may well be no technical, enduring problem but the public would need a lot of reassurance that this moreover, was an intelligent combination if putting those forces there resulted in a restriction of the development of the existing industries in Milford Haven, I do not think that there would be an advantage. This is an area which the Welsh Government have earmarked as an enterprise zone. They want to induce the British Government to give various benefits to encourage the development of the area as an energy generating centre—with offshore wind assembly as well as natural gas and the rest of it. If the nuclear deterrent is competitive with that, it is not clear that there is a net advantage. If it is not, it is not. I cannot help you on that. I do not know what the engineering truth is.

Q357 Lord Forsyth of Drumlean: How many jobs are implied by that development?

Professor Holtham: I do not know. I do not have that in front of me.

Lord Forsyth of Drumlean: At Faslane, the associated job are well over 10,000. The number is very large.

Professor Holtham: I do not think that the existing facilities at Milford Haven would be anything like that. So it would require a very substantial increase. I mean, they want to
develop it as a place to service and assemble offshore wind farm arrays and the Atlantic array.

Q358 Lord Forsyth of Drumlean: Lord Lawson’s question was whether it would be politically unacceptable. Would Milford Haven turn down 10,000 jobs and, I guess, hundreds of millions of pounds, if not billions, of investment?

Professor Holtham: My guess would be that it would go through, but I do not think that it would go through without controversy. There is quite a lot of protest already about the militarisation of south-west Wales. There are lots of low-flying aircraft flights. The Ministry of Defence owns the Mynydd Epynt and uses it as a firing range for troops who are yomping over the Brecon Beacons. There is already a certain military presence in south-west Wales, which is accepted but not entirely uncontroversial. It would certainly create a political storm, but I guess, like you, that that would be overcome if that was the way in which things went. I am not sure that I accept the premise that having your nuclear deterrent in a foreign country is impossible.

Lord Forsyth of Drumlean: It is when that foreign country’s Government are determined to get rid of it.

Professor Holtham: That is true. But then again, the argument about all those jobs in Milford Haven applies. Is there a rent which the Scottish government would regard as adequate? I do not know.

Q359 The Chairman: Perhaps I may ask a question which is not directly economic but could have economic implications. If Scotland were to become independent, is there a demand for a changed relationship from Wales to England in the constitutional sense, in governance and so on? Would there be a demand for greater independence of various aspects of policy?

Professor Holtham: I think so. I think that there are areas where that is the case. Most particularly, Welsh devolution is a bit cockamamie. Unlike Scotland where you have a reserved powers situation, where certain powers are reserved to the centre and otherwise you can do what you like, in Wales there are 20 or 50 areas that are specifically devolved. Within those 20 areas each one has some 40 exemptions overall. It is a bit of a lawyers’ paradise and a nightmare for everyone else. There is a very ragged edge to Welsh devolution, which raises all sorts of issues if you are talking about the West Lothian question, for example. I pretty well defy you to find any law that could be passed through the Houses of Parliament as a purely English law. Given the nature of Welsh devolution, it is probably moving some expenditure from one area into another where the degree of devolution is different and will have an effect on the size of the Welsh block grant. There is no such thing as an English law which does not affect Wales.

One thing that would be advantageous is to move devolution in Wales, however extensive you want it to be, to a reserved powers model, like Scotland. Then try to make it a little cleaner so that it is possible to say that this is a law which affects only England and does not have any first-order implications for Wales. Within that, devolution is sometimes particularly confused, for example, in police matters. I am sure that there are things that the political scientists would point to as being strong candidates for further devolution. My main perception is that it is unnecessarily messy.
Q360 Baroness Kingsmill: Do you think that, having had the—let us suppose—successful example of independence, Wales would have some sense of wanting to increase its independence?

Professor Holtham: As I say, I think that there would be a slipstream effect. People would point to certain extra powers and I think that moving to a reserved powers model would be good.

Baroness Kingsmill: You mean advantageous to Wales.

Professor Holtham: Yes. There are two problems: one large and one small. The large one is the very different position of the two economies. Wales does not have an oil field and it does not have a financial services sector. It is not economically in good shape. It is running a deficit of 25% of GDP. People are realistic about what that means. There is also a minor point, which I always try to explain to Scots by saying, “Imagine that the Highland clearances had not happened and you have 1.5 million Gaelic speakers in the north of the country who do not really regard the rest of you as Scotch because you can’t speak Gaelic. Now try running a national party.” That is the situation in Wales. There is a language division, which has some effect.

Lord Lawson of Blaby: That is why the referendum went the way it did.

Professor Holtham: Yes. It has a restraining effect on the demand for nationhood because, quite illogically and erratically, the English-speaking majority are afraid of being oppressed by the Welsh-speaking minority in an independent state. It makes no sense, but it is a feeling that exists. It is a minor problem compared with the economic situation, but when you put the two together there will not be an immediate demand for Welsh independence.

Q361 Lord Forsyth of Drumlean: If you go down the Scottish route of having reserved powers, will you not get a Welsh Government who promise all kinds of things on the hustings and then argue that they are not deliverable because England is not providing enough money and that they are not fairly treated? That in turn will generate more support for independence. Is that not the lesson that we learnt from the experience of Scottish devolution, which was supposed to do the reverse but has actually resulted in more demand for more powers and more success for the nationalists?

Professor Holtham: Except that in the Scottish case it is possible to argue, without it being obviously preposterous, that Scotland could pay its way. You cannot make that argument about Wales; it is obviously preposterous.

Q362 Lord Forsyth of Drumlean: I understand that point, but does it not make it even more difficult to do as you suggest, which is to go down the reserved powers route, because you separate the ability to raise the revenue from the policy-making, which is the argument that is constantly put for giving more powers?

Professor Holtham: I beg your pardon. When you asked about more powers, I was thinking of legislative power. I think that there is a very strong case for devolving income tax to Wales so that the Welsh Assembly Government has responsibility for raising a substantial slice of its own revenue and therefore cannot make the argument that it cannot do anything because it cannot raise the money or because the English are not giving us enough money. I share with Calman the view that it is an important element of accountability that you have to raise some of the money that you are spending. The report that I chaired took the view that Wales should have some devolved tax powers, mainly income tax.
Q363 Lord Forsyth of Drumlean: I understand that. Yes, you can say, “You can have income tax powers and other powers,” but you get into the same problem that we had and still have with local government finance. Although there may be local revenue-raising powers, they are a small proportion of the budget, so you get a gearing effect for any promise that is made in an election. In the case of local government, people then blame central government for not giving enough grant. In the case of Wales, would they not blame Westminster for not giving enough grant and focus on the inequalities and unfairness of the way in which the grant was calculated? Does that not feed the separatists? That is certainly how I would observe what has happened in Scotland.

Professor Holtham: I understand what you say. I will repeat myself: the issue here is that it is one thing for Plaid Cymru to say, as they do, “We’re not getting enough money from the UK Government,” but then they do not have a credible answer to the question, “Well, if they don’t give you any at all, how is that going to make it better?” They do not have an answer to that. They have to rely on arguments such as, “We’ll fire up the creative instincts of the people and set them all free.” The trouble is whether we are going to take a 30% cut in our income in order to get into that spiritually elevated position. It is not a great selling line.

Q364 Lord Currie of Marylebone: I wonder whether in your work on your commission you found that you could draw any lessons from previous episodes of separation internationally, such as Ireland in 1922 or Czechoslovakia in 1992, or the prospective separation in Spain and Canada. Are there any broad lessons that you can point us to in helping us to understand the consequences of Scottish independence?

Professor Holtham: We of course focused rather narrowly on fiscal aspects of federation and separation, so I cannot say that we took a very high-level view of the politics, culture and whatnot. One thing that was striking about the Czech and Slovak situation was how very much of a non-event it turned out to be. Both parties to that union were absolutely convinced that they were being screwed by the other party. It is a bit like England and Scotland in that sense—both sides are perfectly convinced that the other side is exploiting them. The net transfers were not great; such as they were, they were flowing from the Czechs to the Slovaks. The Czechs were quite convinced that the Slovaks would go down the tubes if they became independent, but it simply did not happen. Indeed, both states have evolved. The difference in income between them has not increased and they have rubbed along. In that sense, although I do not know how much of an example that is, I rather suspect that the same thing could happen here. The bookies tell me that that will not happen anyway and the Scots will not vote for this. Otherwise, the thing that really struck you is the extraordinary diversity of arrangements in different federal states and the extreme difficulty in generalising about them. There is an exception to any rule you think of.

Q365 The Chairman: Professor Holtham, are there any points that you think we have left out that you would like to make?

Professor Holtham: I think that I have made the point, but I would like to repeat it. In the probable event that the Scots do not vote for independence but there is discussion as to what further devolution should occur—what sort of devo-plus they should get—this should be a multilateral discussion. I know that it is very un-British to try to plan constitutional change rather than just react to it, but I think that we should look at this as a multilateral issue and ask questions such as, “If we devolve something like corporation tax, what framework are we going to impose on it?” We should try to take the Welsh and Northern Irish—and indeed the north of England—situations into account as we do it. There is a need
for a sort of clearing house. I am very pleased that your Lordships are playing your part in this. I think that it is very necessary. I have the strong impression that we have had a series of bilateral discussions going on that are not joined up enough.

Q366 Lord Forsyth of Drumlean: To follow up on that—I think that it is a very sensible suggestion—does that mean that you think that so-called devo-max is not a matter that can be determined just in Scotland but is a matter for the United Kingdom as a whole?

Professor Holtham: Indeed. This is very much a personal view and perhaps a bit idiosyncratic, but I do not think that devo-max makes a scintilla of sense. If I am Scottish and I ask myself the question, “Would I rather be in a social union with England or a defence union?” there is only one answer. My demographic structure is less favourable than England’s. I have more deprivation. Any sensible social security system will give me a net transfer. It will also provide robustness, because if the oil price collapses and I cannot afford social security, I am in the union and welfare still gets paid. If I do not think that that is good enough, because I take a different view from that of the Conservative Government in England, I can always augment benefits from my own resources. I cannot see that it is in the Scottish interest to get out of a social union with the rest of the UK. However, given the British penchant for overseas adventures, I am not sure that one would want to say the same thing about defence policy. Are the Scots really enjoying any benefits from invading Afghanistan? I am not so sure. I do not know why you would want to be in a defence union with England and not a social union. It seems to me that devo-max is perfectly the worst of all worlds. Why on earth would you do it? I do not think that it will happen. I think that we are looking at devo-plus, not devo-max, and devo-plus certainly raises issues that must have multilateral implications.

Q367 Baroness Kingsmill: By that, I take it that you mean that, for example, the north of England, Wales and Shetland may have these thoughts about devo-plus, too.

Professor Holtham: Yes. Some of the arrangements that I have seen for devo-plus seem reasonably sensible, but some of them entail quite large transfers to Scotland. All I can say to that is, “Nice work if you can get it, but what about the rest of us?” I think that you have to generalise the discussion.

The Chairman: What about the rest of us? That is perhaps a good note to finish on. We felt that it was important that this issue should be looked at in the context not just of Scotland and the rest of the UK but of the individual other parts of the UK. It has been very helpful to have this analysis from you. As far as Wales is concerned, it is the first that we have had. Thank you very much indeed for coming.

Professor Holtham: Not at all. It was a pleasure.
Introductory Comments

ICAEW welcomes the opportunity to comment on this important and wide-ranging Select Committee inquiry.

Independence in Scotland is ultimately a political question on issues of national identity and future, and as such will be decided by the Scottish people. ICAEW is an apolitical organisation so this response focuses on possible economic implications and the technical challenges a separation of Scotland from the rest of the UK would create. These implications and challenges are not insurmountable but, as a professional organisation for accountants, ICAEW would like to see costs quantified and complexities simplified as much as possible. Independence in itself does not affect the stock of labour and capital in either Scotland or the rest of the UK, and to that extent would not be expected to make a significant immediate economic difference. The overall fiscal stance might not be much affected by independence although the ability to alter tax rates could change the situation. In our response we outline some issues around altering tax rates in a newly independent Scotland. In principle – although there are practical challenges – Scotland could adopt its own currency and monetary policy.

It is important to frame this debate in light of the current Eurozone crisis. There has been a sense that Scotland could leave the UK because it would remain in the wider union of the EU. However the future of the EU – and crucially the single market – has become less clear with no obvious resolution in sight.

SUMMARY

The issue of dividing assets and liabilities is complex, especially having to divide institutions and processes. With public sector employment in Scotland higher than the UK average this may make it more complex. We suggest a GDP based approach, and call on the ONS to produce pro forma national and government accounts for Scotland and the rest of the UK.

These complex questions about division must address benefits entitlement with reference to current or previous residency/domicile. The issue of joint public services is key.

The experience of the independence of Ireland highlight the risks for Scotland in retaining sterling if the country has no influence on Bank of England monetary policy. We point out that Scotland already has three banknote issuers.

There is a need to explore robust and tested financial arrangements and regulatory regimes prior to separation. We consider the role of the three UK-based banking groups registered in Scotland and the difficulties in securing lender of last resort facilities. Constraints are likely to come from both EU and global regulation. Solvency support for banking must also be considered.
Adopting the Euro would incur separation and transitional costs and create ‘winners’ and ‘losers’ when trading with Europe and the rest of the UK respectively. We are doubtful that Scotland would adopt the Euro given current conditions but may have to, making it difficult to then adopt any new Scottish currency.

Paragraphs 24-27

It would be difficult but feasible for Scotland to have its own currency. We cite examples of Lithuania, Latvia and Ireland.

Paragraphs 28-31

There is a lack of clear information on the current tax take in Scotland. Main concerns are around costs and complexity; taxing rights and double taxation issues.

Paragraphs 32-35

The impact of different tax rates raises issues of complexity and administration/collection costs. We mention the taxpayers’ actions to minimise tax and the danger of creating a ‘race to the bottom’, especially with regard to corporation tax.

Paragraphs 36-43

Lessons should be learnt from the current European debt crisis. Robust fiscal rules must be developed and enforced. Cross-border migration should be considered.

Paragraphs 44-49

There could be a divergence in the economies of an independent Scotland and the rest of the UK, and non-tariff trade barriers could emerge.

Paragraphs 50,51

Our recent research shows no early indications that independence would affect UK business. 75% of respondents with sites in Scotland felt it important to stay. We consider headquartering decisions and financial regulation.

Paragraphs 52-56

While Scotland is likely to be subject to the same economic challenges of the UK, ICAEW’s business confidence research shows Scotland can recover from shocks relatively quickly.

Paragraphs 57-59

Lessons should be learnt from the current Eurozone crisis. We emphasise the need for a robust risk analysis and suggest examining the independence of Ireland and others in order to draw valuable lessons for separation.

Paragraphs 60-61

Other issues have been raised by ICAEW members, principally the effects of uncertainty on the economy and around university funding in Scotland.

Paragraphs 62-67

Two appendices are attached: The ICAEW ten tenets for a better tax system and a summary of recent research on the potential effects of Scottish independence on our members.

ABOUT ICAEW

1. ICAEW is an international body based in the UK and operates under a Royal Charter, working in the public interest. The regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council.

2. As a world-leading professional accountancy body, the ICAEW provides leadership and practical support to over 138,000 members in more than 160 countries. Strengthened by the expertise of our whole membership, particularly those in the UK/EU who are interacting with government and institutions on similar economic issues, ICAEW is working with governments, regulators and industry in order to ensure the highest standards are maintained.
3. We believe in acting responsibly, in the best interests of our members and the general public. We act with integrity, creating effective partnerships with organisations and communities worldwide to ensure the highest technical, professional and ethical standards.

4. ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

5. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

6. ICAEW Scotland serves over 1400 ICAEW members across the private and public sectors in Scotland and represents the views of ICAEW members who work in Scotland for local, national and international organisations.

### Division of the UK’s public assets, liabilities and expenditure

How should the UK’s public assets and liabilities, from national debt and reserves to public pensions, North Sea oil and bank exposures be divided if Scotland becomes independent?

7. The division of assets will be subject to detailed negotiations by respective administrations. It will raise complex and contentious questions as each party will seek to obtain the best terms possible. The areas highlighted above are likely to be contentious and reaching an agreement that is satisfactory to both sides will require patient negotiation and a willingness for compromise.

8. While it may be straightforward to value and divide assets, this is not the end of the story. It is also necessary to divide institutions and their processes. This might mean creating new processes and IT systems. For example, how would HMRC be divided and how would it liaise with the revenue in Scotland? Currently HMRC offices and processes are not currently divided in any geographical sense. Would it be possible to separate Scottish taxpayers from existing computer systems and processes?

9. Proportionately more public sector activity is based in Scotland – partly due to UK government policy of locating public sector jobs in Scotland. Government statistics suggest the percentage of public sector workers to population is nearly 10% in Scotland as against 8.4% in the rest of the UK, meaning much higher relative costs for Scotland. If the ratio reduces and there are redundancies in the public sector before private sector investment could create more jobs, there could be additional transitional costs.

10. What transitional period would be needed and who would bear the conversion costs? The fragmentation of services is likely to increase costs and overheads for all, but the effect is likely to be proportionately greater in Scotland. However, this problem may be offset by how assets such as North Sea oil are divided. North Sea oil assets will need to take account of the impact of exploration and decommissioning costs and future tax revenues.

11. In 2010-11, the estimated current budget balance for the public sector in Scotland was a deficit of £14.3 billion (12.0 per cent of GDP) excluding North Sea revenue, a deficit of
£13.6 billion (11.2 per cent of GDP) including a per capita share of North Sea revenue or a deficit of £6.4 billion (4.4 per cent of GDP) including an illustrative geographical share of North Sea revenue. In 2010-11, the UK as a whole ran a current budget deficit, including 100 per cent of North Sea revenue, of £97.8 billion (6.6 per cent of GDP). (source: GERS, Scottish Government, 7 March 2012).

12. While allocation could become highly complex, with different rules for different assets and liabilities, there would be merit in a simple approach that was, for example, related to shares of UK GDP.

13. **As a starting point, ICAEW calls on the ONS to produce a pro forma set of both national accounts and government accounts for Scotland and the rest of the UK, with assumptions in these accounts made clear. This data is most likely already collected by the ONS.**

How would the UK’s joint public expenditure flows, including social security, the Barnett formula transfers and defence spending be affected by Scottish independence?

14. These will be impacted by the policy decisions and negotiations around independence. Deliberations on social security spending, including state pensions, will need to address the entitlement to these benefits with reference to current or previous residency or domicile. The Barnett formula, which is to do with fiscal flows within the UK, would fall away.

15. Another issue is whether any public services would be delivered jointly between the rest of the UK and Scotland and how the costs would be divided — the obvious example being defence.

**Currency, monetary policy and central banking**

**What are the implications of Scottish independence for the operation of the Bank of England? If sterling continues to be used in Scotland, would the Bank of England be required to take into account Scotland’s economic conditions in setting monetary policy?**

16. The experience of the independence of Ireland is instructive. Much will depend on whether Scotland keeps sterling at the time of independence. Ireland retained the link with sterling and it was not until 1978 that it established a completely independent currency. If Scotland retained sterling, it would be a proportionately larger part of the sterling area than Ireland was in the period from 1922 to 1978. Thus, the potential impact on the rest of the UK if Scotland retained sterling would be far greater. The rest of the UK might therefore insist that Scotland has to change its currency, though may be unable to compel it to change, (c.f. Montenegro and Kosovo unilaterally adopting the euro).

17. From Scotland’s point of view, there are major risks inherent in retaining sterling if Scotland is unable to influence the Bank of England’s monetary policy. This is clearly a matter for negotiation, but Scotland’s position would appear to be extremely unsatisfactory if it retains sterling but has no say in the Bank’s monetary policy. It is worth noting that central bank effectiveness partly depends on the clear backing of a
‘parent’ sovereign, and it would not be easy for the Bank of England to serve two countries.

18. However, it should be borne in mind that Scotland already has three banknote issuers, which are required to back these notes fully with Bank of England notes. That could form the basis for a Scottish pound (and would be what economists call a ‘currency board’). However, there would be no Scottish influence over Bank of England monetary policy – but realistically the influence is limited even now because Scotland is a relatively small part of the total UK economy.

**What would be the implications for the stability of the UK’s financial system, and the financial system of Scotland, of Scotland becoming independent and retaining sterling as its currency? Would a Scottish monetary authority offer lender of last resort facilities and how would financial institutions respond? What would be the implications of possibly different regulatory regimes in an independent Scotland and rest of the UK?**

19. Experience of the current problems in the euro zone demonstrate that proper and lasting arrangements need to be designed and ‘stress tested’ against a variety of financial situations. Design mistakes may not be apparent until much later, at which time the financial and economic consequences could be serious.

20. Currently, three UK based banking groups (Clydesdale Bank, Lloyds Banking Group and Royal Bank of Scotland) are registered in Scotland but the majority of their business is elsewhere in the UK. The separation of financial stability mechanisms, including the Financial Services Compensation Scheme and regulatory regimes is likely to influence their future organizational structures.

21. It would be difficult to offer lender of last resort facilities to the extent that the Bank of England would not be Scotland’s central bank. However, where appropriate such operations are indemnified by the sovereign (HM Treasury at present), so the Bank of England might be willing to act on the basis of a Scottish government guarantee.

22. The scope for Scotland to operate a different regulatory regime would be constrained by the extent to which these arrangements are harmonised globally and especially in the EU.

23. Solvency, as opposed to liquidity support, must also be considered. The Scottish economy may not be large enough to take on the contingent liabilities associated with the Royal Bank of Scotland and Lloyds Banking Group. It may be possible to split off some or all of RBS’s ‘non-Scottish’ business into an English domiciled entity. This could probably be achieved without legislation as the UK Government owns most of the economic interest in RBS.

24. **What would be the implications for Scotland and the rest of the UK if an independent Scotland switched to the euro?**

25. If Scotland adopted the euro, it would have important consequences for Scotland and the rest of the UK that would need to be managed in the short-term. It would create further separation and transitional costs. Given the two countries would remain closely linked, currency problems in either country would inevitably have some impact on the other.

26. The additional costs for businesses operating both in Scotland and in the rest of the UK would be significant: with a variety of ‘foreign exchange’ issues arising on a day-to-day basis and requiring significant administrative input.
27. Conversely, the many Scottish-based businesses trading predominantly with euro zone countries could be expected to benefit from cost savings to an equal extent: so there would be both ‘winners’ and ‘losers’ over this issue.

28. Ultimately, in present circumstances it seems doubtful that Scotland would adopt the Euro. However, analysis by Business for New Europe of the EU Treaty legalities around Scotland remaining in/joining the EU are such that it would at least notionally have to commit to joining the Euro. The practical significance is that it would be difficult for Scotland to adopt a completely new currency.

Could an independent Scotland have its own national currency? What would be the practical consequences if it did?

29. There are several reasons (one noted above) why it would be difficult for Scotland to have its own national currency.

30. The experience of Ireland breaking from the link to sterling from 1978 onwards would suggest that it would be feasible for Scotland to have its own currency so that development should be studied in detail. However, world economic and financial situations have changed considerably in the intervening 34 years and the present day dependence on IT based financial systems will result in significant sterling separation and conversion costs.

31. The costs for businesses operating both in Scotland and in the rest of the UK would again be significant, as noted above, but without any savings for Scottish businesses trading with Eurozone countries.

32. Eurozone members Lithuania and Latvia, which are smaller economically than Scotland, have their own currencies – but such currencies in practice are not widely convertible internationally. A separate Scottish currency would impede cross-border trade with the rest of the UK to some degree – though this has not been insurmountable between Eire and Northern Ireland, for example.

Fiscal policy and taxation

What would be the fiscal consequences for other parts of the UK of an independent Scotland?

33. This is a critically important question for both an independent Scotland and the other parts of the UK, the answer to which requires accurate data. However, according to the paper “Devolving Corporation Tax in the Scotland Bill” prepared by the Scottish Government in September 2011: “There are no separately collected figures on the amount of corporation tax raised in Scotland. Figures compiled by HMRC are not disaggregated below the UK level.” Lack of information on the current tax take in Scotland would be a shaky foundation on which to base projections of future tax revenues north and south of the border. Similarly, can current expenditure on state pensions and benefits be accurately split between Scotland and the rest of the UK? In the absence of detailed information estimates can be made, but they would only be as good as the underlying data and assumptions.

34. Likely concerns surrounding fiscal independence would include the additional costs and complexity that would be incurred. The main issues would be around cross-border trading and the incidence of double taxation. This has not been an issue to date, although may become so after Scotland is able to set its own tax rates. It will be necessary to
decide on taxing rights, for example for income tax by reference to residence and domicile of individuals and for companies by where they are incorporated or managed and controlled. Other taxes might be based on where assets are physically located.

35. The UK currently has in excess of one hundred Double Taxation Conventions with overseas taxing jurisdictions. These have been individually negotiated to avoid double taxation by allocating taxing rights and to provide mechanisms for resolving disputes. It seems likely that an independent Scotland with its own tax system could no longer be a party to these Conventions and would need to establish their own.

36. In order to minimise possible problems of double taxation in the UK, it would be necessary for Scotland and the rest of the UK to enter into a comprehensive double taxation agreements in line with international practice. The key issue would be clarity: it would be essential for both countries’ taxing rights to be clearly understood by Government, the tax authorities, businesses and individuals.

What would be the effects on other parts of the UK and on Scotland of an independent Scotland introducing different tax rates? How would businesses and households respond? What are the implications for the UK’s and an independent Scotland’s tax base?

37. Existing Scotland Act provisions have already created a framework for differential tax rates between Scotland and the rest of the UK from 2016 onwards. Our principal concern is that such differential tax rates may create serious, expensive, complicated and unintended consequences for both Scotland and the rest of the UK. Given these issues already exist, an independent Scotland might be better placed to avoid such unintended consequences through a more flexible and adaptable approach to fiscal policy than that permitted under the Act.

38. ICAEW’s Tax Faculty has developed Ten Tenets for a Better Tax System: details are attached as an appendix. Our core principles are that tax should be certain, simple, and easy to collect and calculate. We advocate simplicity in tax systems as a basic core element to aid understanding, compliance and avoid unnecessary costs.

39. When measured against these principles, we are concerned about more complexity within the UK infrastructure and this raises questions about how tax would be collected and administered in an independent Scotland as well as the quantification of the transitional and ongoing costs of collection from a smaller taxable population. These complexities need to be mitigated on both sides of the border. We note the Scottish Government’s plans to establish Revenue Scotland by 2015 to collect devolved taxes.

40. Different tax rates will inevitably result in taxpayers seeking to ensure they minimise taxes where possible. The extent of this will depend upon a number of factors, not just the actual difference in rates, but also the compliance costs and the ease of moving (for example residence status) between the two countries. For SMEs it is only likely to be a problem in the areas closest to the border, e.g. the north of North of England and the Scottish Borders, for businesses that currently trade cross border.

41. However, most large UK companies will have operations on both sides of the border and considerable additional administration costs will be incurred in keeping separate accounting records so that trading profits and losses can be allocated to Scotland and the rest of the UK in accordance with the double tax treaty referred to above. Note that
such costs will be incurred even if the rates are the same on both sides of the border but if different rates apply there will be an incentive to reduce the overall tax burden by either adopting favourable transfer pricing policies or else moving activities from one country to another. If businesses are moved to take advantage of lower tax rates then this could have considerable impact on employment.

42. With differing tax rates, Scotland and the rest of the UK will inevitably become competitors at an international level, with both countries seeking to attract businesses and skilled individuals through the manipulation of fiscal policy. Such competition could be healthy and could benefit either or both countries. On the other hand, there is a risk that a ‘race to the bottom’ for the lowest tax rates could damage both countries and produce no long-term benefit for either.

43. In this context, ICAEW would like to see some form of mechanism in place for mutual co-operation between the two former parts of the UK designed to ensure that future fiscal policy is implemented responsibly and does not lead to a mutually detrimental outcome through low tax rates alone.

44. From a Scottish perspective, independence would provide the opportunity for a more flexible approach to design a Scottish tax system tailored to the specific requirements of individuals living and businesses operating in Scotland. This would enable Scottish tax rates, allowances and reliefs to be better targeted at the needs of businesses operating in Scotland, providing the means to boost the Scottish economy without resorting to a mere crude manipulation of tax rates.

What would be the impact on the rest of the UK’s debt if an independent Scotland issuing debt were to face a sovereign debt crisis? Would the spill-over between the rest of the UK and an independent Scotland require fiscal rules to limit risk exposure? Would they work?

45. Lessons should be learnt from the current debt crisis in Europe. Fiscal rules to limit risk exposure would appear to be necessary and agreements would need to be put in place at the outset for the sharing of risk around flexibility in national economies.

46. The UK as a whole needs to be clear about risks and exposures at the beginning of any process of UK break-up. The old saying ‘good neighbours build high fences’ might well apply.

47. Potential cross-border migration stimulated by a sovereign debt crisis would also be a risk to be considered early in the process.

48. The over-riding need will be to build a robust framework of fiscal rules to survive future shocks and minimise risks. For example, there are questions about whether Scotland would keep sterling or adopt another currency. However, this question also needs to be looked at from the other end of the telescope. Given the lessons to be learned from the economic and financial turmoil in the Eurozone, the rest of the UK would look to reduce potential risks of a Scottish sovereign debt crisis. The rest of the UK might therefore insist that, as part of the price for independence, Scotland either accepts some oversight of its fiscal plans or else it must adopt another currency. Conversely, Scotland’s financial and economic future would be closely bound up with, and largely governed by, the economic and financial position of the rest of the UK over which it had little or no control.
49. If Scotland suffered a sovereign debt crisis the impact on the rest of the UK would broadly be the same whatever currency Scotland adopted. The impact would reflect the loss of trade and other economic factors arising, including any moral obligation on the rest of the UK to contribute to assisting Scotland (i.e. similar to the UK contribution to the Irish bail-out).

50. The issue of sovereign debt sustainability is important as markets are not entirely rational and – partly for historic reasons – are relatively tolerant of sometimes high UK public deficits and public debt levels. It is not obvious that this would extend to the debt of a newly independent Scotland.

**Economic structures, cycles and flexibility**

**Would the economies of the rest of the UK and an independent Scotland be likely to diverge or remain similar? If diverge, how would this affect the rest of the UK? Would economic cycles converge or diverge and what would be the consequences?**

51. Based on experience following the independence of Ireland, it is likely that the two economies will naturally diverge, but given the on-going close connections it seems likely that the economic cycles will have some correlation. Indeed, it could be argued that the purpose of independence would presumably be for Scotland to diverge socially and economically from the rest of the UK. However, to what extent that might be and how it might vary in the economic cycle we do not know and much will depend upon the economic and fiscal policies adopted by each country afterwards.

**Would independence for Scotland affect its trade / current account balance with the rest of the UK? What would be the consequences? Could non-tariff trade barriers emerge over time?**

52. These questions are largely outside our area of expertise. As for non-tariff trade barriers, the position would depend to some extent on whether Scotland and the rest of the UK remain part of the EU and are therefore bound by the EU treaty freedoms that prohibit discrimination. It is possible that non-tariff trade barriers could emerge in time, for example regulatory requirements might diverge and become more onerous in one country, thereby creating a barrier of sorts.

**Would there be more movement of large company/financial institution headquarters from/to an independent Scotland and the rest of the UK? Would Scottish independence have any impact on labour markets across the UK?**

53. Our most recent research (see Appendix II) on the potential effects on business of an independent Scotland shows no early indications that independence would affect UK businesses. However, three quarters of those asked with sites in Scotland think it important to keep their presence in the country for a range of reasons including brand credibility/history and the availability of local specialised skills (especially in oil and mining).

54. A range of factors affects multi-national organisations’ decisions about where to base their headquarters. In general terms, these factors will include political and economic
stability, a convenient location, currency, language, corporation tax rates and investment allowances and incentives, good infrastructure, and an accessible and educated labour force (as mentioned above). They will also value a cost-effective and efficient regulatory structure that is simple and certain and which enables them to plan and invest for the longer term.

55. Given the range of factors and no prior knowledge of what policies would be pursued by a Scottish Government, we cannot comment on whether an independent Scotland would, per se, be more or less attractive for large companies. However, it is inevitable that competition for foreign business and investment would become more overt.

56. In a previous consultation paper on corporation tax in Scotland, ICAEW Scotland discussed the dangers of focusing purely on a potential reduction in corporation tax rates as a way of attracting companies to the country (thus creating the potential ‘race to the bottom’ discussed above); while ICAEW Tax Faculty responded to the HM Treasury consultation document *Rebalancing the Northern Ireland Economy*. In our earlier response we set out some key issues including the need for simplicity, the implications of having more than one corporation tax system in the UK, the need for a detailed cost benefit analysis, and the implications for HMRC, as well as looking at alternative mechanisms and policy options that might work in Northern Ireland. The Committee may find it useful to read our previous documents, which are available on request.

57. No consideration appears to have yet been given to how Scottish Financial institutions would be regulated. Given this is a significant proportion of the Scottish economy, decisions would need to be taken well in advance of a referendum. Would the FSA (or successor organisations) – currently a UK organisation – remain as supervisor, or if a new regulator is to be established, how would it be funded, organised and would new rules be required? London is not a cheap and easy place to do business, yet it remains the primary financial centre in Europe. One reason for this is the strength of regulation. If Scotland were to start from scratch in terms of regulation, how long would it take to gain the trust of the business world?

**What would be the impact on other parts of the UK if an independent Scotland were not flexible enough to respond to an economic shock? Does the rest of the UK adjust more or less rapidly to shocks than Scotland?**

58. If Scotland kept sterling, the rest of the UK would be likely to require robust fiscal rules on risk exposure from the beginning of any new constitutional arrangements. Given current experience of the problems in the euro zone and its impact on the UK, it seems likely that an independent Scotland would be extremely vulnerable to economic problems in the UK, given that the rest of the UK is currently and will probably continue to be its largest trading partner, whereas the rest of the UK is likely to be less vulnerable if economic problems were confined to Scotland – especially if Scotland adopted a different currency.

59. Regarding the question of whether the rest of the UK adjusts more or less rapidly to shocks than Scotland, ICAEW can offer an insight from on-going research undertaken among ICAEW members in business throughout the UK, as follows:
It is interesting to note the speed with which business confidence among Scottish businesses bounced back after the banking crisis that was so keenly felt in Scotland. The chart below picks out the confidence index for Scotland compared to the UK average. In 8 of the 10 quarters from Q4 2008 to Q1 2011, Scotland was the most confident geographical area of the UK. The implication is that Scotland has the capability to bounce back from large shocks, certainly carrying strong levels of confidence compared to the other country with devolved powers (Wales). However one must acknowledge that the banking crisis, while impacting on the Scotland ‘brand’, was then managed by the UK government and the Bank of England.

Lessons from other countries

Are there lessons from the experience of previous separations, such as Irish independence in 1922 and the break-up of Czechoslovakia in 1992, or where separation has been advocated, as in Spain and Canada?

In answering this question, we would point to current problems being experienced in the Eurozone, especially with Greece. In the light of this experience, a robust risk analysis would be required and steps taken to minimise them, bearing in mind that the risk may not be apparent until many years later, by which time the extent of the problems could have reached serious levels.

Evidence of partitions elsewhere may identify potential problem areas and how they were resolved. There should be a detailed study of the independence of Ireland and what lessons can be learned. Much would also depend upon what currency Scotland adopts. Further, the precise set of circumstances may be different – for example, Ireland stayed pegged to sterling for over 50 years after independence. More recent examples of partition include the Soviet Union, Czechoslovakia and Yugoslavia. All of these were undertaken in different circumstances but it may be possible to draw some useful lessons.

Other Comments
We would like to take this opportunity to highlight some other comments and concerns received from our members in response to this consultation, which do not necessarily fit under the specific questions asked by the committee.

The effect of uncertainty

63. As many questions as possible should be explored in advance of a referendum, especially on apportionment of costs and income.

64. Whatever the outcome of the referendum, the uncertainty is likely to be a challenge, as well as an opportunity for business in Scotland. Potential and existing customers and partners will need to be reassured throughout the process.

65. Scenario planning on strategies should be encouraged by companies currently domiciled in Scotland. Key decisions would include where to locate head offices and this would impact on both the UK and Scottish Governments.

66. Evidence suggests that independence discussions are already creating uncertainty with businesses deferring or adjusting plans until certainty is secured. One example is the Feed-In tariff payments regime. One bank manager suggested that unless the loan could be repaid by 2016 they would not lend as they had no certainty the payments would be made by an (independent) Scottish Government.

Universities

67. Scottish Universities receive some £200m for research from the UK Research Councils. They also host major UK wide research facilities, e.g. the UK high Performance Computing facility hosted by the University of Edinburgh. Independence will raise questions about this and similar programmes. If this funding is lost and not replaced, research capacity in Scottish Universities will contract limiting the ability to attract leading researchers.

68. Independence will also change the status of English and Welsh students to those of EU students. This could result in reduced funding into undergraduate teaching in Scottish Universities and a possible reduction in numbers. The current Government estimate of fees from these students of more than £60m a year could be lost.

APPENDIX I

ICAEW TAX FACULTY

THE TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to
resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

APPENDIX II

**Early attitudes to effects on businesses of “yes” vote in Scotland**

**Background**

The Scottish referendum on whether to leave the UK is planned for autumn 2014, and the “Yes” campaign (pro-independence) was launched on 25 May 2012. In April/May 2012, ICAEW took a temperature check of early business sentiment among senior decision makers in 410 UK businesses with customers, suppliers or operations in Scotland. We looked at perceived impact on businesses of Scottish independence, or Scotland remaining in the UK but with greater control over its taxes and regulations (Devo Plus).

**No early indications that independence would affect UK businesses**

At this time (April/May 2012), 76% across the UK foresee no overall impact on their business of independence, with similar responses for Devo Plus (70%). This is largely because Scotland accounts for relatively little of their turnover, and/or they have the view that an independent Scotland would become just another export market.
Interestingly though, three quarters of those with sites in Scotland think it important to keep that physical presence. They cite a range of reasons;

- having invested in buildings there,
- brand credibility/history,
- the need to be physically close to customers, and
- some oil/mining companies have to be there, and they benefit from local availability of skills in their sector.

11 June 2012
The Institute of Chartered Accountants in England and Wales (ICAEW)—Oral evidence (QQ 368-429)

Evidence Session No. 8.  Heard in Public.  Questions 368 - 429

TUESDAY 10 JULY 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Hollick
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord Rowe-Beddoe
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witnesses

Iain Coke, Head of Tax Faculty, and Frank Haskew, Head of Financial Services Faculty, Institute of Chartered Accountants for England and Wales.

Q368 The Chairman: Good afternoon, Mr Haskew and Mr Coke. Thank you both very much indeed for coming. Before we get on to the more detailed questions, I want to thank you for your paper, which raises a lot of the nitty-gritty questions that we are now getting to in various areas. You have put a focus on the practical details.

Could I first ask you to explain the difference between your institute’s and the Scottish institute’s representation? We have had a paper from ICAS as well, and we shall be going to Scotland in October when we expect to have interviews with some of the Scottish accountants.

You refer to a survey you did of business organisations. Was that for the UK as a whole or did you focus on non-Scottish companies: in effect, in England and Wales? Can you also explain to what extent you work together and how much you are different?

Iain Coke: Perhaps I should take this. We are two separate bodies. The ICAEW has around 140,000 members, of which about 10% are outside the UK, and we have around 1,500 members in Scotland. The Scottish institute is a separate body, but we both train chartered accountants. You mentioned our member survey. Perhaps I can give you some more
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information on that. We run an ongoing business confidence monitor where we survey ICAEW members for their views on the state of the economy, in effect asking, “Are you more confident or less confident than you were a year ago?”. As part of that process, we are able to ask some additional questions, which vary from time to time. Earlier this year, just to take a temperature check on views of Scottish independence and its implications, we included a question to seek the views of our members on the impact of Scottish independence. Of the people surveyed, there were around 450 whose businesses had some activity in Scotland. Some were based in Scotland while others either had physical locations or were trading with customers and suppliers there. We asked whether there would be a positive impact from Scottish independence, a negative impact or no overall impact. A small majority of members said that they did not think there would be a significant overall impact, but significant numbers said that they did not know. Those data included everyone with some business activity in Scotland and excluded members whose businesses do not have any activity there. We did look for more information about the patterns within that, and we found that the closer the links to Scotland, the greater the uncertainty about the impact of Scottish independence.

Q369 The Chairman: So some of the people who responded have businesses in Scotland because they are located there or have headquarters there?

Iain Coke: Yes, I would expect that to be the case. However, it is not necessarily the majority of that 450 and I do not have the specific data to hand. Even so, some of them will be based in Scotland.

Q370 The Chairman: Presumably you liaise a lot with representatives of the Scottish institute. To what degree do you share views on this issue with them and to what degree is it concentrated on your own members?

Iain Coke: This is based largely on our members’ views. We share information, but we will undertake our own independent analysis and temperature checks.

Q371 The Chairman: I thank you for your helpful paper. In paragraph 63 you say: “As many questions as possible should be explored in advance of a referendum, especially on apportionment of costs and income”, and in your paper you outline a whole number of areas where there are a lot of uncertainties. How long do you think it would take to get to the point when some of these questions can be answered, given that the referendum is expected to be in 2014?

Iain Coke: It depends on the level of detail in the answers to the questions. We think there are some areas where you can take a reasonably broad-brush approach. Overall, our view is that, should the vote go in favour of independence, the objective should be that you have two sustainable national economies. Having a reasonable apportionment on a reasonably simple basis will help with that. But we think there are great uncertainties. There are some assets and liabilities that it should be reasonably straightforward to apportion between Scotland and the rest of the UK. Hospitals and schools, for example, would obviously go with geographical location. Some of the bigger questions, such as how the national debt is apportioned, also need to be considered, and questions such as the position on Europe and on the choice of currency. Again it would be useful to have clearer understanding of how the division is likely to work.

Q372 The Chairman: We agree with the comment that I have just quoted from your paper. That is why we are having this inquiry of our own. It is uncovering all sorts of areas
where there needs to be detailed negotiation if people voting in the referendum are to have a clear view of what they are voting about. Are you confident that that can be done by 2014?

**Frank Haskew**: If I could, I will come in at this point. Our view is that it would probably take at least a few years after the independence vote to actually flesh out how it was going to work in practice. Just picking up on my area of expertise as head of the ICAEW’s tax faculty, we currently have one national tax administration, HMRC, which is organised on functional and not geographical lines. In relation to revenue and revenue coming in, how would that work? It may be possible at a fairly early stage to say that we will keep HMRC as it is and the tax rules as they are but start with some overarchingly division of revenue received, maybe on a population basis, and only at a later stage move to more of an independent system with possibly an independent Scottish tax system. There are ways in which things could be done, and the timescale might depend on whether one adopted a fairly straightforward system to begin with and then moved at a later date to a more clearly defined or separate system.

**Iain Coke**: One thing that might help in making those considerations is if clearer national accounts were prepared that showed the economies of Scotland. The Scottish Parliament, I understand, has provided some data on how Scottish GDP et cetera would look, but perhaps the Office for National Statistics could attempt to show how Scottish and other UK economies would look, perhaps broken down regionally, because the impacts may be slightly different in different parts of the UK.

**Q373 Lord Shipley**: How quickly do you think those national accounts could be produced? Historically, the ONS has simply said that no one collects data on tax raised by nation or region in any part of the United Kingdom. If there is no way of collecting it, particularly dividing up corporation tax for a company that has many bases but may, for example, do payroll in one part of the United Kingdom, how quickly could that be produced, and could it be done before a referendum in 2014?

**Iain Coke**: It would depend on how crude the numbers were in simple terms. To have some broad assumptions should be relatively more straightforward. The greater the precision, the longer it would take, although I do not profess to be an expert on how easy it would be for the ONS to collect those data.

**Frank Haskew**: Perhaps I may add here that we are already into the 2012-13 tax year. Assuming that you would want your data to cover a complete tax year, logic would suggest that 2013-14 would be the earliest complete year in which you could possibly have data for this. That would suggest that the timescale leading up to the vote is very short to actually get some hard data on this.

**Q374 Lord Levene of Portsoken**: Mr Haskew, following up on Lord Shipley’s question, you said earlier that you thought it would take at least a few years to understand the implications of all this. Your paper, as the Chairman has said, starts to flesh out some of the very serious issues involved which we have been looking at. In the circumstances, do you think it would be desirable to have them set out clearly before a referendum so that people fully understand what they are letting themselves in for?

**Frank Haskew**: As a body of chartered accountants, obviously we work in the public interest and we believe in transparency and accountability. We would be firm advocates of people having all the right data to make the sensible decision. On the face of it, while ultimately it would be a policy question for the Scottish people to decide, they would need to have the facts put in front of them at the time of an event.
Q375  Lord Levene of Portsoken: And you are inferring from that that the timescale that is available will make it very difficult to achieve that?

Frank Haskew: We heard earlier that the window for getting hard data on geographical revenues from Scotland is already closing quite quickly.

Q376  The Chairman: We now come to the detail based on your paper. Can I start by asking you this? In your evidence you suggest that a simple share of GDP approach would be the right way to divide assets and liabilities between an independent Scotland and the rest of the UK. Do you see any assets or liabilities being an exception to this approach, or do you think they can be applied across the board?

Iain Coke: I should probably clarify the written evidence. We think that a simple approach should be taken, but as I said before, for some assets a geographical basis is the obvious approach to take. There are other areas where there are international conventions on how things such as mineral resources are shared, but on the principle of keeping things simple a good starting point is to look at international conventions on how cross-border issues are dealt with. Some of the trickier asset areas, such as share of long-term liabilities, that are particularly key, may be where you take a GDP approach.

Q377  The Chairman: You have already talked about the ONS material and you suggest in your evidence that it would need to produce and provide pro forma national accounts. Over the past few years, the Scottish Government have produced provisional national accounts that extend back to 1980. While it is still provisional, are you asking the ONS to produce something additional or different?

Iain Coke: I think it is about getting agreement on the basis of calculation, so it is probably an expansion of those numbers. I do not think that they cover the balance sheets as well. They talk about the GDP side, but from an accountant’s point of view there are income and expenses. However, you also need to look at assets and liabilities as well as the long-term potential funding costs of things such as public sector pensions, the costs of activities such as decommissioning nuclear power stations and other activities that impose long-term potential costs.

Q378  The Chairman: So there are quite a number where a simple GDP approach just would not work?

Iain Coke: Whatever approach you take is not going to be an ideal solution. There are a number of ways of allocating things. To an extent, if you pick one, agree on it and follow it through, you may need some adjustment mechanisms when you look at things overall, but as a starting point, there may be worse ways of doing things. There are also international conventions, such as on social security costs. Within the EU there are conventions on how social security costs work for someone from the UK who moves to France and vice versa. On those things we would recommend taking the international conventions.

Q379  The Chairman: On the tax side, you mention in your paper the difficulty of separating out the corporation tax accounts for Scotland from the rest of the UK. Is that only for corporation tax, or do you envisage similar difficulties with other taxes such as personal taxes?

Frank Haskew: I am not aware that there are any formal data that analyse revenue raised in Scotland, and indeed until you know on what basis you are potentially going to levy taxes,
that could be quite a difficult thing to achieve. So far as we are aware, there are no hard and fast data in this area on any taxes at the moment.

**Q380 The Chairman:** Does that include personal taxes?

**Frank Haskew:** I am pretty sure that there are no data. As we said, the UK has a national tax system because HMRC operates across the UK. That really is the whole thrust of it. We are going to have to start recreating these data.

**Q381 The Chairman:** How long do you think it will take to break down the data and come to some conclusions?

**Frank Haskew:** We are coming back to the questions that we have had before. We have a long lead time. As Iain said, we can probably do broad-brush calculations in a relatively short period, but to move on to having fully analysed data will take time.

**Q382 Lord Lawson of Blaby:** Perhaps I may continue with that a little before going on to the expenditure side. I can certainly understand how, in advance of a referendum, one would hope to get more data than we have at the present time, although that would be subject to questions of any changes made to the systems and the arrangements afterwards. Even so, you could get guidance, and I can see that you could get the data, but I am not clear whether any data-mining exercise is now going on either in Scotland or in the United Kingdom as a whole. If something is going on, please do inform us, but I do not think we are aware of any great exercise being undertaken.

In any case, while you can get some data beforehand, the evidence that we have been given by a whole lot of witnesses—I think the first to say it, although others have too, was Professor John Kay—relates to the sort of questions we have asked you to comment on. There is no international law that determines how this split or separation should work, so it is all a matter for negotiation. That cannot and will not occur until after a referendum in which the Scottish people vote for independence. Do you agree with that?

**Frank Haskew:** I think that is right. This is a multi-step process, and the first thing we are going to have is a referendum. At that point, depending on what happens, there will be detailed negotiations both from the Scottish side and from the rest of the UK. For instance, on tax, we will need to thrash out a tax agreement, for want of a better term, and how all that is going to be devolved. Until you get down to that level of detail, this is very difficult. You can make estimates of how much revenue you are actually getting in Scotland, but unless and until you decide on the basis of taxation, those figures may not tally with the reality of the system you end up with.

**Q383 Lord Lawson of Blaby:** Might not this take a considerable time? Moving on to the spending side, I am not quite sure what paragraph 14 of your evidence means. Can you elucidate it? I understand the last sentence and that the Barnett formula is to disappear, so do not bother to comment on it. Everyone is clear that that must be the case. It is an earlier part of the paragraph that I do not understand.

**Iain Coke:** What we are trying to say is that state pensions and public sector pensions in particular are large numbers that are not backed by a fund of assets, and calculating how to allocate them will be a difficult negotiation. For example, if an Englishman has worked in the Scottish Office in London for most of his career and then retires to Scotland, should his future pension be paid for by Scotland or the rest of the UK? I think that that will be quite a difficult negotiation.
Perhaps I can make an analogy in a different area on a much more micro level. We have found that some of the most difficult situations for our members, the most difficult disputes they get into, are when partnerships dissolve. Sometimes a form of conciliation service is needed to get people talking to each other and moving forward on an amicable basis. In an independent Scotland, given that the Scottish economy and that of the rest of the UK are so closely intertwined, you want them to work well together. To avoid getting into difficult discussions, we probably need to be aware of the fact that there might be a need for some mechanisms for moderating the discussions. There may be advice that the World Bank or the IMF could give on what would be a fair basis for allocation. I go back to the point I made earlier. You want two sustainable national economies and not to have either of them burdened with too large a share of the long-term liabilities. You want each to have their fair share.

Q384 Lord Lawson of Blaby: Perhaps I may try to clarify this for you, and if you disagree, please feel free to say so. I do not believe for a moment that either we or anyone else in the United Kingdom would go to the IMF for arbitration. I do not think that it is the IMF’s job either. You mentioned pensions and social security spending, and you have talked about entitlement. There is in fact no entitlement except an entitlement under the law of the land as it is at the present time. However, the law can and no doubt would change in these circumstances. As you say, there is no fund for pensions. It is a pay-as-you-go system and even more so for other benefits. However, there is a precedent which you mentioned in response to a question put by the Chairman. Let us assume for the time being that an independent Scotland would wish to join the European Union, and it did so. That is certainly the official policy of the Scottish National Party. As you mentioned, there are plenty of British pensioners in France and in other countries of the European Union. Surely that would be the obvious precedent. If Scotland were a fellow member of the European Union, you would apply exactly the same rules as are applied when people move to France, the Costa Brava in Spain or wherever else. Do you agree that it is inevitable that that would be followed? As I understand it, the arrangements differ from one country to another because of the bilateral agreements between the countries concerned, so there is scope for negotiation and discussion and, of course, for disagreement. If the European Union precedent were followed—I use the French precedent as a form of shorthand—what would that mean?

Iain Coke: I think I agree about the state benefits and the state pension. It may be a slightly different situation for public sector pensions, so I imagine that the UK would still pay the pension of a public sector worker who retires to France. Splitting those may be more complex.

Q385 Lord Lawson of Blaby: But we do not pay upratings, do we? As I understand it, the normal system is that you receive the same pension that you had when you moved and you do not get any subsequent upratings. Is that not the case?

Frank Haskew: That certainly has been my understanding of it, but I am not quite sure if it has changed in recent years.

Q386 Lord Lawson of Blaby: Obviously we need to inform ourselves about that. Leaving aside public sector pensions, which are slightly more complex, what about the state pension and social security?

Iain Coke: So far as social security is concerned, a residence test may be the simplest answer, which I think is broadly the EU position.
Q387 Lord Lawson of Blaby: It would almost certainly be the same, and indeed it would be odd if it were not. The same applies to British people who go and live in other countries inside the European Union.

Frank Haskew: I want to amplify that. The rest of the UK and Scotland would need to enter into a comprehensive double tax treaty. That is for certain. They would also need to have a double contribution agreement, as we do with other countries. I think it would follow a very similar model, but there would obviously be questions about past contributions and entitlement based on NIC contributions over many years.

Q388 Lord Lawson of Blaby: But NIC contributions do not give you any entitlement at all. It is a phoney insurance scheme, is it not?

Frank Haskew: NIC contributions still give you some contributory rights, but I agree that they have been heavily scaled back over the years.

Q389 Lord Lawson of Blaby: Those rights are really what the law of the land says at any particular time and that can be changed. But if it is the European Union precedent, which seems to be the obvious thing to do, have you worked out what the consequences would be.

Frank Haskew: No, we have not, but should the Committee be interested, we would be happy to have a look at it and come back to you.

Q390 Lord Lawson of Blaby: Thank you. I have one last point. You have mentioned something which I must say had not occurred to me, which is the problem of the Scottish universities—the very fine Scottish universities—which are funded by the UK research councils. You suggest, and I am sure it must be true, that that funding would cease. Are the Scottish universities aware of this, and are they apprehensive about what the consequences might be?

Iain Coke: This is another one where, if you want more information, we can provide it.

Q391 Lord Lawson of Blaby: You raised it right at the end of your evidence.

Iain Coke: This is one of a number of areas where you have national bodies that contribute. How they provide such funding is something that the Scottish Government would need to consider.

Q392 Lord Lawson of Blaby: Perhaps I did not make myself absolutely clear. What I was asking is this: are Scottish universities aware of the position and are they concerned about it? Have they looked at it?

The Chairman: We are talking about funding from the research councils.

Iain Coke: I imagine that they are very well aware of how they are funded, and I think they would be better able to provide you with information on it.

Lord Lawson of Blaby: But so far as you know they have never spoken out publicly about it.

Iain Coke: I am not aware of that.

Q393 Lord Levene of Portsoken: Your paper addressed the issues with each of the different currency options: sterling, euros or groats for an independent Scotland. Did you come to any conclusions on whether, for example, sterling would be the best option?
Iain Coke: Broadly speaking, the status quo is the sensible starting point for thinking about the choice of currency. We have looked more closely at some of the data from the Scottish Government’s accounts to consider the trading levels. From those, approximately 60% of Scotland’s exports under an independent Scotland would be to the rest of the UK with 40% going to the rest of the world, and just over 70% of imports would come from the rest of the UK with around 30% from the rest of the world. That suggests that trading with the UK is the most significant element. Trade with the rest of the UK as a percentage of Scotland’s GDP is about 30%, so overall exports would be around 50% based on those numbers and current activity levels. The figures suggest a very open economy but one that is heavily interlinked with the rest of the UK. That suggests that certainly there is more economic logic to a currency union with sterling than with the euro.

There are advantages and disadvantages in any currency union, as there would be with an independent Scottish pound. The disadvantage of a Scottish pound is that potentially large transaction costs would be involved in what is a significant part of the business. There are also the significant costs of changing a currency. Setting up a new Scottish currency would almost certainly be an expensive process with uncertain economic benefits.

Lord Levene of Portsoken: You went on to say that you believe that the potential impact on the rest of the UK of an independent Scotland retaining sterling would be far greater than when Ireland used sterling. Could you explain that a little more?

Iain Coke: It is based on probably a quite a low base point. When Ireland used sterling as its currency, it did not really have a significant impact on the rest of the UK. We have said that the Scottish case might have a greater impact on the economy. There are two reasons for it, simply that the Scottish economy is larger as a percentage of the GDP of the rest of the UK than the Irish economy was in those times. Also, when Ireland adopted sterling there was a wider sterling currency area because other parts of the old empire had in effect adopted sterling. It is a simple numbers game. In terms of what the impact on the rest of the UK would be, as we see it the biggest one is potential perceptions—the infection by one currency of another. We think that the eurozone crisis has shown that in lending sovereign debt, people need to take into account the credit ratings of individual countries, not of the zone as a whole, and the markets are very conscious of that. The impact on the rest of the UK of the Scottish economy might be minimal. Because of the way the markets would react, it would be based on the Scottish economy. The rest of the UK’s economy would be provided with its own market ratings.

Lord Levene of Portsoken: You also went on to say that if an independent Scotland were to use sterling, that would have no influence in setting the policy of the Bank of England because that would be very unsatisfactory. I wonder whether you could elaborate on that. You suggested that it would be unusual for a central bank to serve separate countries. What would be the way around that?

Iain Coke: As part of the settlement you could come to an agreement that the Bank of England would consider the impact on the Scottish economy in setting interest rates. That is one possible measure as part of a settlement. Alternatively, Scotland could in effect go it alone. I think we mentioned a couple of countries that have unilaterally adopted the euro with no impact on economic policy. I think that this is an important question that needs to be considered before the settlement is reached.

The Chairman: It is difficult to see what the solution is. In paragraph 17 you say that it, “would appear to be extremely unsatisfactory if Scotland retains sterling but has no
say in the Bank’s monetary policy”. Even if Scotland had one member on the Bank’s Monetary Policy Committee, that is unlikely to have a great influence on the Bank’s general attitude. You cannot have the tail wagging the dog.

*Iain Coke*: Some of that is the sense from our members in Scotland that you do not want an economy without levers on it. There is an alternative view that currently Scotland has a limited impact on the Bank of England’s interest rate policy setting anyway because it makes up 10% of the economy. Moreover, the two economies are reasonably similar. They may develop and become more differentiated, but as things stand they are reasonably similar. It may be that our thinking on this issue has evolved after we submitted our written evidence.

**Q397 Lord Lipsey:** Surely it would only be a problem if the economies became very divergent, such if the huge power of the trade unions in Scotland leads to runaway inflation north of the border, whereas their complete suppression south of the border means that we have negative inflation. I could absolutely see the point then, but until now the two economies have run more or less convergently, so it does not seem obvious why an interest rate policy that is right for England is going to be wrong, ipso facto, for Scotland.

*Iain Coke*: Yes, and you could have a Scottish central bank to manage a Scottish currency, Scottish reserves and so on, but in the Scottish economy it would need to buy sterling in effect from somewhere, and if the Scottish economy ran out of kilter, it would be difficult. If we think about this in other terms, it is relatively easy for people to move around in the current UK. We have a common language and if prices do get out of kilter in one part of the economy, while you do not have the full free movement of people there is a greater degree of it. There may be some natural damping down with that. If the two economies significantly diverge, at some point in the future, like Ireland, you might consider separate currencies. But, as you say, at this point the two economies are broadly similar.

**Lord Lipsey:** It is just your words “extremely unsatisfactory” rather than, say, “a trifle awkward” that have struck me.

**The Chairman:** I think you mean that it would be extremely unsatisfactory from the Scottish point of view, do you not?

*Iain Coke*: I think we do, and I apologise for those words. Politically, some people in Scotland may find it very unsatisfactory.

**Lord Lawson of Blaby:** Bad luck.

*Iain Coke*: There are emotional arguments as well as economic arguments here.

**Q398 Lord Rowe-Beddoe:** Before we explore a little more an independent Scotland retaining sterling, can I go back to your quite correct emphasis on the requirement for pro forma national accounts? My question on that issue is very simple. Have you or any other members of your organisation talked to the Office for National Statistics about this?

*Iain Coke*: We have not, no.

**Lord Rowe-Beddoe:** So you do not know the consequences of such requirements or of issues of time and so forth.

*Iain Coke*: No.

**Q399 Lord Rowe-Beddoe:** Fine. Thank you. Let us assume that we have an independent Scotland and that it is going to retain sterling. I suppose that it is a decision that would need
to be agreed on both sides of the border. In those circumstances, how would the Bank of England position itself to be, or would it have to be, the lender of last resort?

*Iain Coke:* There are two aspects. Lender of last resort may be less of a concern because it is about immediate liquidity. When the Bank of England provides lender of last resort facilities, it asks for assets to support them—pledging assets. The Bank of England could act as the lender of last resort for an independent Scotland if that was part of the settlement. If it did so it would ask the banks to pledge assets, and the more uncertain the valuation of those assets, the higher the collateral it would ask for. If it was in the form of UK government bonds, it might ask for 5% added collateral. So, to lend £100 it might ask for £105 of assets to support that lending. There might be some form of Scottish government guarantee to support that as well, but ultimately the banks themselves would provide assets to support the lender of last resort capacity.

The more difficult question is on the solvency regime, so if the banks needed a capital injection, who would provide it? This again will be a politically sensitive area. It may be difficult for an independent Scotland fully to stand behind all the banks that are based in Scotland as they currently stand, although there are some precedents elsewhere. The Benelux Governments worked together on a bail-out of the Fortis bank. It would not be in either Scotland’s or England’s national interests for one of the major national institutions to go down, no matter where they were headquartered, because the large ones are UK banks whose networks cover both Scotland and the rest of the UK. It is a question that is probably better agreed up front rather than waiting for it to happen.

*Q400 Lord Rowe-Beddoe:* In your evidence you raised the concept that a Scottish Government could offer HM Treasury a guarantee to make good losses incurred by Scottish institutions. Is that credible?

*Iain Coke:* In terms of lender of last resort status, it probably is. In terms of a full solvency bail-out, it is more difficult. You would need to look at the impact on capital markets. Experience from Ireland during the financial crisis showed that it can be difficult for a small economy to stand behind major institutions. The alternative example is Switzerland, which again is a small economy and has some very large banks.

*Q401 The Chairman:* In that context, could I ask about paragraph 20 of your evidence where you say, “Currently, three UK-based banking groups (Clydesdale Bank, Lloyds Banking Group and Royal Bank of Scotland) are registered in Scotland, but the majority of their business is elsewhere in the UK”? The point you go on to make is this: “The separation of financial stability mechanisms, including the Financial Services Compensation Scheme and regulatory regimes is likely to influence their future organizational structures”. Can you spell out a little more what you mean by that?

*Iain Coke:* The financial services industry is based on trust and confidence. The banks might maintain a headquarters but reorganise and have a separate “rest of the UK” operation that to an extent was ring-fenced and part of the UK Financial Services Compensation Scheme. It is a mechanism for providing confidence to depositors that there is a weight behind the institution.

*Lord Smith of Clifton:* That is what the Irish banks have done following the recent eurozone crisis. They have separate companies over here that are backed under UK legislation.
Q402 Lord Tugendhat: Perhaps I could ask this question. In the event of Scotland voting for independence and then clearly wishing to diverge from the rest of the UK, would you advise the Bank of England, if you were in its position, to take on the responsibilities we are talking about? The Bank of England has quite a difficult job working in one sovereign state and in conjunction with one fiscal authority. Would you, in all honesty, advise it to take on all these roles for two sovereign states?

Iain Coke: I think that the Bank of England also has a role in maintaining financial stability. The potential impact on financial stability of some of the institutions is quite significant. I expect the Bank of England to be concerned about all matters in the UK financial system as it currently stands. That includes a number of major institutions that operate in London but are headquartered overseas—American banks, German banks and so on. All of them are of concern to the Bank of England, the FSA and its successor bodies. There are moves at the European level to look at how major cross-border institutions are supervised in order to secure better co-ordination of the supervision, and potentially for the European Banking Authority to have greater powers over cross-border supervision. So at the supervisory level, there are mechanisms to deal with cross-border issues.

Q403 Lord Tugendhat: With the greatest respect, that does not quite answer the question. The United Kingdom is very concerned about what happens in the Republic of Ireland, but the Bank of England had no responsibility, fortunately, for the welfare of Irish financial institutions, banks or otherwise. The United Kingdom Government chose to assist the Republic of Ireland, but that was a different issue. My question is a much narrower one. I am not talking about what is possible or what precedents there are, because at one level almost everything is possible. However, if you were called upon to advise the Bank of England to take responsibility for the sort of things we have been talking about—conduct of monetary policy, lender of last resort, maintaining financial discipline and so forth—in two sovereign states rather than only in one, could you say that it would be a sensible thing for the Bank of England to do?

Iain Coke: Providing solvency support goes above the Bank of England and is ultimately a matter for government decision-making. It is generally considered as things happen. I do not think that the UK Government expected before it happened that they would need to provide solvency support to the banks as they have. When you are in a crisis, and we will talk about what happens in a crisis here, you need to take action to maintain the stability of your own economy.

Lord Tugendhat: Trying to look at these matters not just from the Scottish point of view but, in accordance with our terms of reference, in terms of the impact on all parts of the United Kingdom, I cannot say that I come away from your responses confident in the belief that the rest of the United Kingdom would benefit from the Bank of England taking on the responsibilities for the part of the United Kingdom that had chosen to break away. That is the conclusion I draw from the answers you have given me.

Iain Coke: I think the rest of the United Kingdom might have concerns about a major split of assets, particularly publicly owned assets, and having them headquartered in another jurisdiction where it does not control their regulation, along with other questions. It may appear that I am trying to avoid the question. It may just be my Scottish sensitivities, having appeared in front of the Scottish Parliament, which was very interested in the impact of choice of headquarters et cetera.
Lord Smith of Clifton: Might I ask you whether, as a Scot, you intend to retire in Scotland?

Iain Coke: Given how retirement is going, that is a long way in the future.

Lord Rowe-Beddoe: Would you envisage that the Bank of England could actually regulate Scottish financial institutions?

Iain Coke: I would imagine that Scotland would want its own financial regulator.

Lord Rowe-Beddoe: It would want its own.

Iain Coke: The Scottish financial sector is not just about three large banks plus Standard Life. There is a fund management sector and a number of other large financial institutions.

Lord Rowe-Beddoe: Yes, but we are talking about the use of sterling as a currency. That is the context, is it not?

Iain Coke: I imagine that it would want its own financial regulator. Aspects of that are simplified when setting the rules because a number of them are set on an international basis. You could have an agency system where the Scottish regulator in effect paid the rest-of-the-UK regulator to do some of the supervision work under an agency agreement. That might be a short-term solution or potentially a longer-term one. Financial services regulation is really important for building your credibility as a financial sector, so I imagine that Scotland would want its own regulator.

Lord Rowe-Beddoe: Lastly, can I ask you about the scenario of both countries using sterling as their currency? What about capital flows, seeing how quickly they can move across borders today? Do you think there would be more or less stability?

Iain Coke: I have not looked at that specific question.

Lord Hollick: Can we turn to the question of how the Government fund themselves using sovereign debt issuance? You say in your evidence that, “The UK as a whole needs to be clear about risks and exposures at the beginning of any process of UK break-up”, and go on to say that, “Good neighbours build high fences.” The overriding need would be to build a robust framework of fiscal rules to survive future shocks and minimise risks. How do you imagine that will be done? How will these rules be made to work? Can you give us any international examples of such rules working between two independent countries?

Iain Coke: The point about good neighbours building high fences comes back in part to the point that it is in the mutual interests of Scotland and the rest of the UK to have sustainable economies. Part of the answer is how you would allocate the existing UK debt. Raising new debt in capital markets may take care of itself, given how each new economy works. They will need to raise their own finance, and the stronger the credit rating the easier it will be to raise money on the capital markets.

Lord Hollick: But as we see at the moment in the eurozone crisis, it is difficult for independent countries to work together around a common set of fiscal rules. Are there any examples internationally of that working effectively?

Iain Coke: None comes to mind, but there may well be. We may be able to look into that further.
Lord Hollick: There are quite a lot of examples. I can think, for instance, of Scandinavia, where relatively small countries with different currencies can work together. They have many economic links, yet they have a much greater degree of control over their fiscal policies. They seem to be able to manage their affairs effectively and have good access to international capital markets. You may correct me and perhaps give us some details, but if I recall correctly, the credit rating of the Scandinavian countries is actually rather strong. There seem to be some examples of countries that can stand separately, notwithstanding the great integration of their economies.

Iain Coke: You can also look at Canada and the US, although Canada is a lot bigger than Scotland both physically and in the size of its population. It has a similar split. One of the issues with a separate Scottish currency is the transition cost of moving towards it. The Scottish economy would need to stand on its own feet by ensuring that the economy was managed in such a way that it would have relatively less impact on the exchange rates of sterling when compared with the UK. If it did not manage its finances in a sound way, it would find it difficult to stay within a currency union. It might find that it would then need to explore setting up its own currency.

Q410 Lord Hollick: Perhaps its credit rating for access to international markets, certainly in the first few decades, would be very dependent on the price of oil, because that would be one of the largest factors in the economy.

Can I come back to an interesting point you made at the start of your response about splitting up the debt? As you say, I presume that, under any settlement, some UK sovereign debt would have to travel to Scotland. Would that remain denominated in sterling, or are there examples of other splits where one of the countries has redenominated or reissued into another currency?

Iain Coke: I think that would be dependent on Scotland adopting a different currency. Even if it did, it would still be possible to retain the existing debt in sterling. At times, countries offer debt in a currency other than their own, but Scotland would need to repay the debt at those levels. I think that may need lawyers to go through the terms of the actual bonds to work out how that might happen.

Q411 Lord Hollick: Would the separation be by percentage of GDP?

What benchmarks would you expect to be used to decide on how much debt goes with Scotland?

Iain Coke: I think we said before that GDP should possibly be the starting point, but until you have the full picture and you can think about how other assets and liabilities are split up, it may be to an extent one of the balancing components. You might adjust those figures to provide a fair basis overall for making the allocation.

Q412 Lord Lipsey: Would an independent Scotland need to have a double taxation agreement with the rest of the UK? Would that be complex or relatively simple? Lastly, would it need a whole series of such agreements with every other country in the world?

Q413 Frank Haskew: I think that Scotland will clearly need to have a double tax agreement with the rest of the UK. That is the foundation of international trade and commerce, tax and resolving disputes, difficulties, and indeed allocating taxing rights. As part of any independent settlement, a comprehensive double-tax treaty will need to be negotiated, and it is a question of negotiation. Again, each side will have to come to the table
and come up with an agreement. My guess is that that would be based fairly solidly on the OECD model treaty, which is the industry-standard approach. So, yes, we would need to have a treaty. Also, as I said earlier, we would need to have a double contributions agreement for things such as national insurance, and we would probably need an agreement for inheritance tax as well. So we would need a fairly comprehensive set of agreements covering a wide range of taxes, and they would all need to be negotiated.

Moving on from that, the UK currently has 120 double tax agreements, which is the largest number in the world. We are obviously assuming that the rest of the UK, if you like, carries the current UK treaties and law with it. Scotland, given that they are bilateral treaties with other countries, would have to start negotiating new treaties with other jurisdictions. Ireland, I believe, currently has 66 double tax agreements, and they take time to negotiate. Sometimes it can take many years, so it will be a long process, I would have thought, for Scotland to put together a set of international tax treaties.

Q414 Lord Shipley: Could you now address the issue of differential tax rates in an independent Scotland as compared with the rest of the United Kingdom, and what scope there actually is for differential tax rates in Scotland?

Frank Haskew: There has been quite a lot of debate so far, particularly around the rate of corporation tax. Obviously with the experience of the Republic of Ireland we have seen that the 12.5% corporation tax rate has been successful in encouraging foreign direct investment. We are already seeing in Northern Ireland a groundswell to try to have a lower corporation tax there. As we said earlier, we need two sustainable economies coming out of any independence, so Scotland will be looking for growth as well as for investment. I think there would certainly be pressures for a lower rate of corporation tax than the current UK rate.

Moving on to other taxes, with VAT rates, we are more constrained by EU rules. With income tax, we already have the Scotland Act 2012 which re-emphasises the capability of Scotland to set independent rates up to a point. Obviously that is devolution, and independence would be a further step from that, but I think it would be fair to say that there will be a need for the new Scottish Government to have sustainable revenues because they are going to need a sustainable economy from day one. We have already seen this at the UK level, but we have a large fiscal deficit. Governments will therefore naturally be cautious and very anxious to maintain revenue flows, so my guess is that if we absent corporation tax and some of the other tax rates, with the possible exception of things such as stamp duty and land tax on immovable property, there will probably not be many immediate major shifts and differences in rates.

Q415 Lord Shipley: Can I dig a bit further on the subject of corporation tax? You referred to the pressure in Northern Ireland to reduce corporation tax levels. You indicated that Scotland might want to have a lower corporation tax level, but in your evidence you say at paragraph 42 that you do not want a “race to the bottom” for the lowest tax rates”, and in paragraph 43 you call for “mutual co-operation between the two former parts of the UK”, so that there is no “mutually detrimental outcome through low tax rates alone.” You then indicate in paragraph 44 something that I had not fully understood, which is that you would want a “flexible approach to design a Scottish tax system tailored to the specific requirements of individuals living and businesses operating in Scotland”. You go on to say that this would provide “the means to boost the Scottish economy without resorting to a mere crude manipulation of tax rates”. As I say, I had not fully understood that. Is it simply that there might be more foreign direct investment because the inducements from Scotland
might be greater than the inducements available in the rest of the United Kingdom? Is it that or is it something else?

Frank Haskew: Again, it is not just foreign direct investment. If Scotland wants to become a sovereign country, this will be about its ability to have a tax system that suits its particular environment. For instance, Scotland might look to encouraging manufacturing and therefore to offering higher capital allowances for plant and machinery, or indeed to adopt some other system that encouraged investment. Given that it already has an extensive oil and gas industry, it might want to look to a different oil and gas regime from the current one. An independent Scotland will obviously have different levers fiscally from what it currently has, and therefore there would be scope for the Scottish Parliament to use those levers to what it thought was the best advantage for Scotland.

Q416 Lord Shipley: Would there then be a requirement on companies north and south of the border to have separate accounts for tax purposes? How would the accounting regimes work north and south of the border for companies?

Frank Haskew: In tax terms, Iain can probably answer on the accounting and legal side, but I do not think that it will be that much different from what already happens with companies operating internationally and in other jurisdictions. At the very least, if you were operating in Scotland through a branch of your activity, for Scottish corporation tax purposes you might be required to prepare branch accounts for that Scottish activity and to submit a Revenue Scotland branch account tax return. Those are things that you would not have been doing under the current laws, where you just submit one corporation tax return. However, the fundamentals and the mechanics would not be that much different from operating a branch in, say, Paris, where you would need to deal with the French tax authorities.

Q417 Lord Tugendhat: I want to ask two questions about that. You speak as if Scotland would be a completely independent country in this respect, but I believe that the SNP’s policy is that it wishes Scotland to be a member of the European Union, so it would need to undertake negotiation in order to become a member of the EU. We have seen the great hostility that the Irish tax rates have created in France and Germany in particular. There is nothing that France and Germany can do about those, other than lean on the Irish, and the Irish have resisted. Can one be sure that a condition of entry might not be that Scotland operated within certain parameters? In the light of the Irish experience, might tax feature in the negotiations over EU entry?

Frank Haskew: I do not think that this will be an easy one for an independent Scotland. The fact is that the UK is currently boxed in by international obligations and EU obligations, so that is not a new problem. However, I can see that, if Scotland becomes independent—I am not an expert on the legalities of this, but I assume that Scotland would need to make a fresh application to join the European Union—just like the independence settlement that the UK and Scotland would have to enter into, that obviously presents an opportunity for the EU to come up with a settlement. There will be bargaining as to what would be the requirements to become a member of the EU, and I suspect that corporation tax could well be one of those. Corporation tax could well become a sort of bargaining tool.

Q418 Lord Tugendhat: That is exactly my point. We do not know what the outcome would be, but any decision would not rest unilaterally with the Edinburgh Government but would be affected by the negotiations with the EU and with London. When you say that there will be levers available to an independent Scotland that are not available now, that is correct, but the corollary to that is that there would be levers available to the rest of the
UK Government that are not available now. Clearly, if Scotland instituted a tax regime that was designed to be attractive to inward investment and therefore deleterious to the interests of the northern part of the rest of the United Kingdom, including Northern Ireland, one's assumption would be that the rest of the UK would seek to mitigate that advantage. Otherwise, one would have the race to the bottom that is mentioned in the paper.

**Frank Haskew:** That clearly would be a danger. The Irish experience has been very much based on increasing foreign investment into Ireland. The danger here would be of substitution—investment that would have gone elsewhere in the UK could just move to Scotland— which is a totally separate position to the Irish experience. That position would be, I think, problematic.

**Q419 Lord Smith of Clifton:** We have already touched on this, but perhaps we can go into it in more detail. In your written evidence, you suggest that an independent Scottish Government may not have a large enough tax base to carry the contingent liability of a future large bank failure. You refer to “splitting” large institutions based on business location. Would this need to be a full legal separation? I assume that it would.

**Q420 Iain Coke:** As your Lordships will know, the Vickers commission has already proposed a form of ring fence on UK banks, so in a different context there are structural ways of looking at this issue. Another issue is that, when it comes down to the share of assets, the UK Government is the major shareholder in some of the large institutions, and the UK Government may take the view that they do not want very large institutions to be based outside the UK by moving to Scotland—where there is not the financial firepower to support them or to take on the contingent liabilities—because those are so significant to the economies of the rest of the UK. As a major shareholder, the UK Government would, I am sure, be able to influence the choice of locations. Now, that runs into a lot of political sensitivities, not least because of the name of one of the largest institutions.

**Q421 Lord Smith of Clifton:** Is there any evidence that the Scottish financial institutions are concerned about the consequences of possible new financial arrangements between an independent Scotland and the rest of the UK? Do you expect any financial firms to migrate in either direction?

**Iain Coke:** We have not had information on that, but we have found, based on the survey mentioned earlier, that those organisations with a presence in Scotland—whether UK organisations with a presence in Scotland or Scotland-based organisations—did not expect any significant change in their physical locations. For some, that was because of heritage; for some, it was because of the need for physical locations; for some, it was because they have invested heavily in Scotland; and for some, it was to be closer to their customer base. In those terms, that may not indicate significant movement. We have not had indications from financial institutions that they would seek to move their headquarters. I think that you would need to ask those institutions for their views. It will be important for any major institution to be sitting under a credible regulatory regime. It may be that the financial markets themselves may pass some judgment and place pressure upon them to move.

**Q422 Lord Smith of Clifton:** In Canada, in anticipation of possible Quebec independence, there was a flight from Montreal to Toronto and elsewhere in Canada. As we move towards a referendum, if the polls are going the wrong way, might there be the same anticipatory migration?
Iain Coke: It may be too soon to say on a lot of these questions and issues. Many of our business members have said to us that, because there is so much uncertainty over what the settlement will look like, they are not able to plan for such an uncertain event. Businesses will have their own views, and I think that there are some differences in opinion. I know that the Committee received evidence from the CBI and the Institute of Directors, and I would not want to repeat their evidence, but to an extent some businesses say, “There is too much uncertainty here, so it is too early for us to talk about that.”

Lord Smith of Clifton: Of course, there was too much uncertainty in the Quebec case, which is why some firms decided that it was prudent to move out of Montreal.

Iain Coke: I have not seen any indications that that is starting to happen.

Q423 The Chairman: In the discussions you have had with them, has there been any indication of the key factors that would affect their decisions? For example, you raised some issues yourselves. Did they arise as a result of pressure or indications from some of your members that they are crucial to them?

Iain Coke: Some of the indicators come from the survey information that I referred to about why people are remaining in Scotland. Those are unprompted or free-form responses about what factors are important. This is coming from people who have business interests in Scotland.

Q424 The Chairman: But there is nothing from the financial institutions, the banks and others, to indicate that these are the critical issues that they will want to see resolved, otherwise they may locate elsewhere?

Iain Coke: I do not have that information in my head. I have seen people asking questions, but I do not have it in the front of my mind. If you like, I can see if we can put something together.

The Chairman: It would be helpful to have another note on it if we could.

Q425 Lord Tugendhat: I have a question that relates to your survey: business confidence sentiment appears to have improved faster in Scotland than in the rest of the UK. You ask what the reasons for that may be and whether it will continue. Would you explain your index, please? Does it compare the kingdom of Scotland with the rest of the UK, or does it compare Scotland with the other regions of the UK? In the comparison, has business confidence sentiment in Scotland improved faster than in all the other regions of the UK? Do you see the point I am making?

Iain Coke: We conduct the survey on an overall basis, but we include some cuts of it. To provide for this inquiry we have looked into how we could split it on the basis of location and the regions. The graph in the table shows what we are comparing: Scotland against England, Wales, and the overall level. We found that confidence rebounded quicker and we returned to positive levels of confidence. Basically we ask, “Are you more confident or less confident than you were a year ago?” Generally the stable state is by some way more confident, but it dipped to “less confident” for a time earlier in the crisis. Scotland was the first country where we noticed that it went back to more confidence. We have provided a little more analysis, and it has probably now slipped back towards more average levels. Indeed, GDP growth in Scotland is slightly below that of the rest of the UK. There was a confidence effect, but whether we and our economic advisers are more confident about the Scottish economy than the rest of the UK is quite difficult to say.
The Institute of Chartered Accountants in England and Wales (ICAEW)—Oral evidence (QQ 368-429)

The Chairman: Gentlemen, in a moment I have to chair another meeting in the House of Lords, so I am going to ask Lord Lawson to take the Chair for the rest of the hearing.

Q426 Lord Tugendhat: Thank you for explaining that, because in a number of other areas such as GDP per head and so on, we have comparisons not just of Scotland and the rest of the UK, but Scotland and London versus London and the south-east, or Scotland versus the south-west, or Scotland versus the Midlands. Given the preponderance of England in the economic rate of the United Kingdom, it seems to me that more meaningful comparisons are made between the different regions. I do not know whether you would agree with that. England covers both the wealthiest parts and the poorest parts.

Iain Coke: Yes, we are able to break down our data further, but beyond a certain level they start to lose statistical relevance. We go so far and then not too much further. We may have the data more generally, but the interesting point is that at one point in early 2009, Scotland's confidence recovered more quickly than it did in the country overall. It has evened out now and it is still quite fragile.

Q427 Lord Lawson of Blaby: We have nearly finished. If you will allow me to do so, I shall chair the meeting from my own seat. Clearly, if there is Scottish independence, a lot of political issues will arise from that, but they are not within the competence of this Committee to discuss. I only mention it because there are obviously very important political dimensions to this. As far as the economic issues are concerned, all we have elicited from you so far, and I am sure you are right, is that there are a whole lot of complications. Apart from those complications, will there be any economic consequences as a result of Scottish independence? For example, do you or your members think there will be a sudden release of Scottish entrepreneurship and enterprise as a result of the new-found independence?

Iain Coke: The debate on Scottish independence is more about self-determination than the economics. Ultimately you will have the same stock of capital, people and goods across the UK.

Q428 Lord Lawson of Blaby: I am talking more about people's behaviour. Do you expect to see any changes?

Iain Coke: It may allow greater investment in, or a different way of investing in, skills etcetera. I am not sure that we will see an immediate change in the way people act and behave.

Q429 Lord Smith of Clifton: It will be a sort of Olympic Games boost—allegedly. We are all going to have a boost as a result of the Olympic Games, or we are going to come to a complete standstill in London.

Iain Coke: I think an economist might be better placed to answer that. There may be some short-term benefits, as we saw from the jubilee.

Lord Lawson of Blaby: Scotland, I am sure, will undoubtedly benefit from not having the Olympic Games, but it does not require independence for that benefit to accrue.

Thank you very much indeed for coming here and giving us the benefit of you and your members' wisdom. There are one or two small points on which you have undertaken to write to the Chairman with further evidence. That aside, I think that concludes this evidence session. We are very grateful to you.
1) The Institute of Chartered Accountants of Scotland ("ICAS") is the professional body of accountants. We represent around 19,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body; we do not take a political stance and will not take a stand for or against any Scottish independence referendum proposal.

Fiscal policy and taxation

2) ICAS welcomes the opportunity to contribute to discussions on the issues arising from Scottish independence. In this submission we address Questions 3a and 3b, Fiscal policy and taxation.

Question 3 a

3) It may be obvious, but a point worth emphasising at the outset is that the debate on the impact on Scotland, as well as other parts of the UK, of an independent Scotland with a separate tax base is in danger of being conducted in a void. At this stage, there are no proposals for what might be the tax system of an independent Scotland, albeit a consultation has just been announced on proposals on the replacement for stamp duty land tax devolved by the Scotland Act 2012. Without progress on the design of any tax system for an independent Scotland, it is not possible to reach any conclusion on the impact of such a system for any part of the UK. The main conclusion that can be reached at this stage is that uncertainty results from the lack of tax system proposals to assess this impact, and that work is required to address this uncertainty, following which an informed debate would be valuable.

4) In order to stimulate consideration of the issue of tax in an independent Scotland, or in any further tax devolution, and indeed to highlight the complexity of the issues in designing a tax system, ICAS recently initiated a members debate based on a thought leadership paper “Scotland’s Tax Future; What Tax System Would Scotland Want?”, the text of which is attached at Appendix 1. This paper will inform future contributions by ICAS to the debate on Scottish independence and/or further tax devolution and is expected to provide evidence for future inquiries.

5) In the absence of proposals for a tax system for an independent Scotland, consideration of its impact has to be based on a set of assumptions. There is a crucial caveat: - there has to be a clear understanding of what those assumptions cover and how such assumptions might affect consideration of the questions posed. The tax system of any country is made up of a cohesive set of rules, which define who pays tax and on what they pay tax (the tax base), the operation of any reliefs, relationships with other tax jurisdictions, compliance obligations and penalties for failure or evasion. Administrative machinery is essential, possibly including deduction at source and tax collection.
mechanisms. Tax rates are the final element, but they are only one element of the impact of an overall tax system on an economy and the individuals and businesses living and operating within that economy. Assumptions must be made for each of these aspects for an independent Scotland to answer the questions posed.

Question 3 b

6) To address the question as regards tax rates, it needs to be remembered that there are a number of UK tax rates, any one or more of which might be assumed to be varied, in any combination, under any independent Scottish tax system. The Finance Bill 2012 provides that UK companies will pay corporation tax this year at 24%, or 20% where profits are low (30% or 19% for ring fence profits), but at a marginal rate of 25% where profits exceed the low profits limit. Individuals may pay income tax in the tax year 2012/13 at 0%, 10%, 20%, 32.5%, 40%, 42.5%, 50% or 62.5% (where personal allowances are clawed back), and these rates can vary annually. Individuals may pay capital gains tax in 2012/13 at 0%, 10%, 18% or 28%. The Scotland Act 2012 allows only variation of some of these rates; those at 20%, 40% and 50% and only on non-savings income. As regards consumption taxes, VAT rates may be levied or varied, depending on the membership status of an independent Scotland within the EU, and operate currently at 0%, 5% and 20%. Excise duties on alcoholic drinks may change. Property taxes levied as business rates or on the sale of property, such as stamp duty land tax, are also to be considered but, as devolved (or devolving) taxes are already under consideration by the Scottish Parliament. When revenue generation from tax is to be maintained, any cut in rates in one area is likely to be balanced by an increase in rates in another, by the same government. In view of the point made above at paragraph 5, regarding the need to understand the assumptions in the design of the overall tax system, the impact of any variation of tax rates in Scotland in practice is likely to involve more complex analysis than a simple “higher or lower” approach adopted in some discussions. The comments below are in this context.

Individual impacts

7) The general observation could be made that most people do not like paying tax and, given a legal and legitimate choice, are likely to opt to pay less tax rather than more. Attempts to pay tax at lower rather than higher personal tax rates within the UK - capital gains are taxed at lower rates than income, for example - have resulted in a considerable amount of anti-avoidance legislation within the UK tax system. Likewise, there are extensive provisions in the UK tax legislation to prevent tax leakage from the UK tax net to overseas tax jurisdictions, particularly low taxed areas. The individual behavioural approaches and responses to the tax environment would reasonably be assumed to continue should tax rates differ between different parts of the UK, which may require additional legislative provisions, depending on the policy response taken.

8) One key issue to be addressed by the UK government would be whether any independent Scotland would be simply another non UK, overseas tax jurisdiction as regards the rest of the UK, or any “special relationship” view would be taken. From a tax technical perspective, the question would be whether Scotland would become non-UK for these purposes or whether the current UK anti-avoidance provisions for transactions or individuals in non-UK regimes might be in some way, relaxed. Policy and administrative effort is likely to be needed to identify whether, and what, double tax
treaty between Scotland and the rest of the UK tax system might be needed, and the
terms of the treaty. Future consideration would need to be given to whether that
debate would be part of any potential future independence settlement or would follow
thereafter. In summary, not only is a Scottish tax system design needed, in order to
determine the impact of independence on all UK taxpayers, but the rest of the UK tax
system consequences also require policy design decisions and responses to be
formulated.

9) It may be worthwhile to consider a practical example. Take an individual taxpayer living
in London and with savings in a postal/internet bank account at a high street retail bank
based in Edinburgh.

When that Scottish based financial institution pays interest on the savings the interest
might be paid net of a Scottish basic rate income tax (again, depending on the
independent Scottish tax system) similar to the UK income tax withheld at present at
20%. That Scottish tax might become “foreign” tax for the purposes of determining a
UK tax liability, although current tax law would allow it to be offset against the UK tax
liability on the same amount, that requires an additional tax return claim. Repayment of
any excess Scottish tax deducted would be determined by the terms of that Scottish tax
system and any double tax treaty between Scotland and the rest of the UK, or,
alternatively, different legislative provisions may be enacted in both jurisdictions,
applicable EU rules permitting. This also applies in the mirror scenario, where an
individual living in Edinburgh had savings in a retail bank based in London. It might be
that individuals would decide to keep their tax affairs simple by keeping funds within
their domestic tax regime. Whether that would result in the movement of funds
between institutions in different jurisdictions, or whether those jurisdictions adapted
their international business structures to ease the position of the individual saver is a
matter at present of pure conjecture. Until more of these uncertainties are addressed,
we come again to the conclusion that it is not possible to assess the impact on
individuals in this example situation. We can only begin to identify areas on which
clarification would be helpful to a future analysis.

10) The above example highlights that tax impacts rarely arise in isolation; an individual’s
decision on which savings account provider to save with is also likely to be determined
by factors such as the currency and interest rate offered in that jurisdiction, any financial
guarantee arrangements and the regulatory and control environment of the financial
institution. Tax impacts are also linked to a country’s welfare regime. Where there is
high dependence on the state for support, there may be higher taxes levied to pay for
that. Where there is greater dependence on private provision, taxes may be lower and
savings incentivised through the tax system. Taxes rarely occur in isolation of the
wider environment.

**Business impacts**

11) Businesses conducted by individuals in the UK are within the income tax system.
Businesses conducted in the UK by companies are within the corporation tax system,
and it is these businesses that are considered in this part of this submission. The impact
on businesses from a change in corporate tax rates is dependent, as described above, on
the nature of the overall tax systems or assumptions made about it. If the key
assumption were made, that independence affected only corporate tax rates, then the position is approaching that which ICAS commented on in relation to devolving corporation tax to Northern Ireland in its submission to HM Treasury in June 2011 “Rebalancing the Northern Ireland Economy”. In that, ICAS expressed concern around the consequence to corporation tax law as it would affect the rest of the UK. The views expressed represented those of members of the Institute consulted in recent years over Scottish tax devolution issues, updated by those from several tax committees comprised of members with considerable experience on corporate and cross border business tax issues. It follows that the more changes to a tax system that arose through independence, the greater the scope for other impacts to arise.

It must be emphasised that the comments were made at the start of a debate on different and very specific proposals, and the debate is moving on to one where there is a need for more research, evidence or discussion tailored to the prevailing economic circumstances of Scotland and the UK. The main points from the June 2011 ICAS submission, relevant to this inquiry, are set out below.

12) The concerns expressed in respect of devolving corporate tax powers to Northern Ireland were the same as those for Scotland, which were included in the final report from the Calman Commission published on 15 June 2009 as “Serving Scotland Better: Scotland and the United Kingdom in the 21st century (Final Report)”. Specifically, the evidence provided in that report, is summarised below:

1) The potential for divergent rates of corporation tax across the UK to create economic inefficiencies as firms react to considerations other than commercial factors, and indeed harmful rather than efficient tax competition.

2) Evidence that a cut in Scottish corporation tax would attract more profit shifting behaviours than create real economic activity. This is an increasing issue in the electronic age and with video conferencing. The application of anti-avoidance provisions relating to profit shifting would have to be widened to deal with this, adding unwelcome administrative complexity for all UK businesses, not just those in the specific devolved jurisdiction.

3) The potentially significant additional administrative burden and tax compliance costs for companies throughout the UK and HMRC from changes necessary to monitor profit-shifting through, for example, transfer pricing legislation. In particular the exemption currently enjoyed by many small and medium sized enterprises would need to be reconsidered if devolved corporation tax powers are to be effective in achieving their aims, given the predominate business profiles in each jurisdiction, even if the devolved corporation tax rates do not vary significantly from the main UK rate. Determining tax residence of companies, branches and permanent establishments would also create additional burdens.

4) The case for substantive reduction in the possible rate of corporation tax for Scotland was considered to be limited in the short term if the level of public services were to be maintained, at least until or unless Scottish Parliament revenues could be raised from other sources. However, the risk if more than one jurisdiction within the UK has corporation tax varying powers, of a “race to the bottom” is likely to be
5) A key driver to devolution of tax powers was the accountability of the Scottish Parliament; this was thought to be better achieved through devolving powers on taxes other than corporation tax, particularly those with a closer connection to the electorate.

6) The volatility of corporation tax receipts on a localised basis rather than from the UK economy as a whole was a concern, given that European Union state aid rules do not permit any shortfall to be subsidised by the UK government in such circumstances.

13) We saw, and see, no case for considering the Northern Ireland tax issues as sufficiently distinct from those of Scotland to reach a different conclusion, particularly around tax competition and complexity.

14) There were other key aspects of tax policy making in the UK which were relevant considerations.

1) Firstly, the principle of aiming for stability and certainty in tax matters at a UK level has been greatly welcomed as a means of making the UK as a whole more competitive on the international stage. Any devolution of corporation tax powers to different parts of the UK would reduce stability and certainty, so could reduce the attractiveness of the UK as a whole as well as the particular jurisdiction. This could make any changes counterproductive.

2) Simplification of the tax legislation and the practical operation of the UK’s self-assessment regime have been called for consistently and we support the Government doing more in this area. Devolving corporation tax powers will require additional efforts from businesses and their advisers working across the UK achieves less, rather than more, simplification.

3) In considering the potential for a reduced corporation tax rate of 12.5% for Northern Ireland (or any rate materially lower than an income tax rate) the behavioural consequence of unincorporated businesses seeking to incorporate to take advantage of this rate needs to be considered, along with any evidence that it would stimulate economic activity on a standalone basis. The UK experience of the years 2000 to 2005 with a 10% and then 0% corporation tax rate gave a marked demonstration of this and resulted in an overall reduction in tax payable on those earnings; we have not seen any evidence that additional economic activity resulted from that approach, hence the lower rates were abolished in 2006.

4) Finally, evidence from members raises serious concerns as to the impact on HMRC resources, and whether HMRC would be able to cope with either the changes required or implementation of such devolved powers at any stage in the current spending round. We have expressed in the past concerns over delays and service levels at HMRC, which were also addressed by House of Commons Committee last year. Any additional resources required will have to be fully costed, should any devolved power be required to meet such costs. There may be both fixed costs, which will be presumably incurred up front, when the expected revenue generation
will be undetermined, and variable costs of operating increased legislative burdens in, as suggested above, areas such as transfer pricing.

Appendix 1 – “Scotland’s Tax Future; What Tax System Would Scotland Want?”

Introduction

ICAS – the professional body of accountants – is in an interesting place when it comes to tax devolution.

By tax devolution we mean any form of control of taxes passing from Westminster to Holyrood, whether under the current Scotland Bill, emerging discussions on full fiscal independence, or anywhere in between. As probably the single largest body of financial and tax experts in Scotland, with members throughout the world, ICAS has the depth of knowledge and experience to inform any debate over tax devolution, highlighting opportunities, pitfalls, administrative issues or behavioural responses. We have a wide range of overseas experiences and insights into the workings of the best, and less successful, practices. The principles are the same whichever part of the UK may seek or obtain tax powers, but when aligned to the political landscape, the Scottish example has particular salience. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. So it is in the enviable position of having both the key competencies and focus to inform, and, arguably, lead the debate on the most interesting question of 2012 – what tax system would Scotland want?

This paper is not written with a political perspective, or to address the single, narrow topic of what the rate of a particular tax should be; instead it approaches the issue from a much broader and more challenging perspective. It seeks to share ICAS insights into the many complex issues and decisions involved in tax system design, whether this design is driven by the necessity of raising revenue, the opportunity those new tax-raising powers might bring to deliver more innovative or better funding solutions, or a mixture of both. It seeks to broaden the discussion well beyond the debate on the current Scotland Bill provisions, which use as a basis the existing UK tax system and some limited tax varying powers. It also contributes the experience of decades of work which ICAS members and staff have undertaken, often without public profile, with the UK Government and its agencies on the shared agenda of a better-balanced outcome for all tax stakeholders. This paper also refers interested readers to recent relevant research work in this specialised field.

The UK tax system has many imperfections; the complexity that comes from over 200 years of accumulated drafting and tinkering; challenges regarding the fairness of the sharing of the tax burden, and difficulties with HMRC computer systems and administration. Although any transition to fiscal devolution would have to start from here, what exactly is the destination? What tax system would Scotland want? What tax system should any Government of Scotland propose to meet the required revenue-raising targets as well as wider key principles, such as fairness, high levels of acceptability and compliance, low costs of collection and ease of administration? How practical and cost-effective would any transition be from the current system? To take matters forward, this paper divides these topical and highly important issues into six key questions that need to be explored.
The aim of this paper is to develop these questions and stimulate debate amongst members. Whilst the debate cannot abandon the practicalities of any tax system change – which may limit, perhaps severely, any aspirations or wishes for change – nevertheless it is worthwhile focusing on what a tax system can and should achieve, to also inform the approach to those practicalities. Once members’ insights have been gathered, the output and topics for debate will be shared more widely amongst interested parties. Members’ comments are requested by the end of May 2012.

Key observations

Conclusions can be drawn on a way forward once the wider debate mentioned above has taken place. However, some observations are already worth making.

Firstly, the Scottish Government has at present neither an established mechanism, nor the expertise or resources to respond alone to these questions. The reservation of tax powers to Westminster means it has to be questioned whether the Scottish Government has the full understanding of the complexities of the operation of a tax system to enable it to opine authoritatively on this topic. It needs to address this gap urgently if any worthwhile progress is to be made to meet public expectations that it is making any credible attempts to move the tax devolution agenda forward in the optimum fashion. It would be helpful in the discussion regarding devolution (whenever and under whatever provisions that takes place) to know when and how these questions might be addressed. After all, raising revenue will be fundamental to the operation of any new constitutional arrangement, and the outcome of the debate could have a very direct and personal impact on every Scottish taxpayer. ICAS is happy to contribute the skills and expertise of its members to discussions to take this forward, and to suggest sources and analyses of interest and relevance.

Secondly, the complexity of tax systems around the world and their interaction, both structurally and operationally, is more than anyone would set out to design now. This complexity should not be underestimated. The current UK tax provisions are little understood or believed except by those who have spent their careers trying to navigate through the thousands of pages of legislation, guidance, forms and deadlines; a matter not to be taken as an expression of professional or intellectual arrogance, rather one of sad realisation based on sometimes painful practical experiences.

Thirdly, the general public are often dissatisfied and confused by their interactions with HMRC, and might vote for any change as a promise of improvement. But what is this change to be? You do have to start from here. As anyone who has looked at any isolated change to the tax system recently, such as the brief foray into the zero and 10% corporate tax rates in the past decade would know, the scope for getting any major change wrong is massive and can have serious consequences for tax yield. There is also much opportunity to learn from other regimes, existing expert studies and the talent and expertise pool in Scotland and of Scots.

Finally, the design of a new tax system, or any form of tax devolution, is so large a responsibility it cannot and should not be rushed. It will be far from easy to design and to implement. The inevitable efforts and pain need to be because the case is made based on research and evidence, that something better can and will be delivered. Will it be worth it,
and why? Political leaders and others may be interested in the observation in the Mirrlees report “Tax by Design”\textsuperscript{11}:

“In addition to administrative practicality and the difficulty of turning economic intentions into robust legislative language, proposals for tax reform are, of course, constrained by politics – not least the unfortunate observation that those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful.”

If early tax devolution is decided upon, it will only be practical to adopt the current UK tax system with as little change as possible, but with the administrative system costs to be borne. A fresh approach will probably take at least a decade of effort and disruption to achieve. But not to take those steps could be to compromise on principles and opportunities, for the reasons set out in this paper. That could lead voters to the stark question: is there then a real point to tax devolution?

The key questions

It is proposed that six key questions need to be answered to move the debate forward, and determine what should be on the tax agenda for Scotland. Each of these is addressed in overview below. One caveat however: this is not intended as a complete thesis but rather an overview, based on existing research and publications, and ICAS experience, from which insights and ideas might be drawn. Other questions and approaches will no doubt emerge, and the issues of practicalities can be addressed as a next step, but an agenda for a debate is always useful.

The starting point for a new tax system is a blank sheet of paper. There is only one assumption; that raising taxes is essential to fund public services. It may be helpful to apply the debate to known or given factors, such as the population profile of Scots and business base as at the start of 2012, but only insofar as it may prove the revenue-raising adequacies of the tax system once designed, not to affect the design.

Question 1 - What principles should determine the ideal tax system for Scotland?

Developed economies’ tax systems are a relatively modern phenomenon, most having seen exponential growth in the last 50 years. Tax systems are also man-made, by politicians with a generally limited understanding of the detail of what they do and limited control over the tax administrations they appoint as operators.

It follows then that the people should shape the decisions on the governing principles to be applied, and the establishment of tax policy, by engagement in the debate with elected leaders and policy makers. High-level engagement is perhaps more practical than universal involvement in the detailed drafting of the legislation and the design of the administrative steps that put those principles into practice and make the tax system a reality. But an understanding of the consequences is relevant to the decisions on principles; these consequences need to be considered without allowing them to impede progress on design.

Thinking about tax from the basis of principles, through policy, to practice, is neither new nor particularly controversial for Scots. Adam Smith started this in 1776 in his “Inquiry into

\textsuperscript{11} Available from The Institute of Fiscal Studies website at http://www.ifs.org.uk/mirrleesReview/design, page (iv).
the nature and causes of the Wealth of Nations”, with four maxims with regard to taxes; the burden proportionate to the ability to pay (sometimes called a progressive tax approach), certainty, convenience and efficiency of collection. Many of these principles were reflected in an exercise undertaken by The Institute of Chartered Accountants in England and Wales in 1999, when it identified “Ten Tenets for a better tax system”. These comprised principles behind a better tax system; that a tax system should be: statutory (enacted and scrutinised by Parliament), certain, simple, easy to collect and to calculate, properly targeted, constant, subject to proper consultation, regularly reviewed, fair and reasonable, and competitive.

Similar themes were echoed when the current UK Government defined its view of the principles for the UK tax system in 2011 as:

- “Taxes should be efficient and support growth;
- Taxes should be certain and predictable;
- Taxes should be simple to understand and easy to comply with; and
- The tax system should be fair, reward work, support aspiration and ask the most from those who can most afford it.”

These short and simple principles are rather neat. Scotland can come up with its own, or have a different emphasis. It is when these principles are translated into policies and legislation that it becomes more interesting, as trade-offs, contradictions and piecemeal developments start to add weaves of interaction and complexity. To understand more about these issues, and prepare for the next questions on the list, time would be well spent with a read of the 2011 Institute for Fiscal Studies Mirrlees Review, “Tax by Design” (or even just its introduction). That paper’s detailed examination of the topic raised further concepts and 21st-century factors influencing policy designs, such as:

- the changing importance of particular business sectors in the economy
- the changing demographics in the working population and households
- the interaction with benefits systems (negative taxes) in addressing inequality in incomes
- globalisation, particularly the role of technology in international business transactions
- the influence of the European Union, with its control over VAT and dislike of tax havens.

The debate in recent months has focussed on the competitiveness of a tax system, particularly focussing on the headline corporate tax rate. For the purposes of this exercise, this particular question would ask where competitiveness as a principle would sit in the relative priorities of the tax system design, rather than fix an answer or target rate.

One caveat however, the European Union’s rules on tax systems, and State aid in particular, cannot be ignored – unless of course Scotland is not part of the EU. The European Parliament is also considering enthusiastic proposals by a number of European countries, towards a Common Consolidated Corporate Tax Base; effectively an EU set of tax rules for companies based in the EU, overriding domestic provisions, except for decisions on tax rates. Disputes over EU tax issues take a long time to resolve.

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12 Available from the ICAEW website at: [http://www.icaew.com/~media/Files/technical/Tax/Tax%20policy/Ten%20Tenets%20for%20a%20better%20tax%20system](http://www.icaew.com/~media/Files/technical/Tax/Tax%20policy/Ten%20Tenets%20for%20a%20better%20tax%20system)
13 HM Treasury website at [http://www.hm-treasury.gov.uk/tax_index.htm](http://www.hm-treasury.gov.uk/tax_index.htm)
14 Available from The Institute of Fiscal Studies website at [http://www.ifs.org.uk/mirrleesReview/design](http://www.ifs.org.uk/mirrleesReview/design)
15 Available from The Institute of Fiscal Studies website at [http://www.ifs.org.uk/mirrleesreview/design/ch1.pdf](http://www.ifs.org.uk/mirrleesreview/design/ch1.pdf)
The answer to Question 1 sets the aspirations and principles to underlie the rest of the tax system design.

**Question 2 - Should tax play a wider role than raising revenue?**

Wider policy issues can sometimes enhance, and sometimes confuse, tax principles. What other role, if any, should tax play in a future Scotland?

The tobacco industry tax has for a long time now been associated with the costs of treating the health consequences of smoking, regardless of whether that was its original purpose. The recent debate on the costs to health and health systems of alcohol abuse, even with significant alcohol duties already applying has raised this as an issue again, albeit in Scotland as a minimum pricing issue given the lack of tax powers.

A choice may be made to address the obesity issue with a tax on selected foods; that debate has been taken forward recently by Denmark in its introduction of a tax on foodstuffs with a higher fat content, and Hungary with a similar response but a broader categorisation including sugar. Sugar taxes in fizzy drinks are under serious consideration in parts of the USA. In all of these, tax is seen as a route to influence behaviour against consumption, based on what a government considers unhealthy.

Moving beyond health, Bill Gates' report to the G20 leaders Cannes Summit in November 2011 also supported carbon tax measures, to address climate impacts and address issues of social responsibility and redistribution of wealth on a global scale. These principles can also be localised; the UK already has a landfill tax aimed at encouraging recycling but is redistribution of wealth a design feature to build in, and how?

This might also be a time to consider whether national insurance contributions should be recognised as a tax, in that they generate revenue for current public spending outflows, rather than as a set aside to fund future retirement provision on a compulsory contributory principle, or both.

After addressing Question 2, the system design principles at least start to take shape.

**Question 3 - Who should pay tax in Scotland?**

The Mirrlees report mentioned above included recent tax yield and demographic statistics for the UK, which can be taken, at best, as a proxy for the shape of those statistics for Scotland for the purposes of starting this debate. (Let no-one be misled, there are no official statistics for tax paid by those in Scotland, simply because there has never before been a need to measure them and the mechanism has never been set up. This is discussed further under question 6 below).

The first need is to define who would, and would not, be a Scottish taxpayer? Start with individuals, where we can look to recent work in connection with the proposed Scotland Bill provisions to allow limited income tax varying power to the Scottish Government. (Companies currently have a separate tax regime.) Both the UK and Scottish Governments took a straightforward approach to taxation of individuals, fitting those limitations, of

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17 See observations on the new Institute for Fiscal Studies project to investigate the impact of these types of policies, available at [http://www.ifs.org.uk/publications/5712](http://www.ifs.org.uk/publications/5712)

regarding “Scottish taxpayers” as a subset of “UK taxpayers”, broadly on the basis of where their main home was. A number of anomalies were found as to the treatment of mobile workers; naturally any existing anomalies in the determination of a “UK taxpayer” would carry through. That taxpayer base has the advantage of relying on known rules (albeit the UK rules are likely to change in 2013) and having an automatic default for an individual Scottish taxpayer to being a UK taxpayer, so setting out the tax boundary with the rest of the UK.

However, if starting with a blank sheet of paper, would the Scotland Bill’s approach to income tax be the optimal one? An example of one disadvantage of the approach is given by the current definition of a “Scottish taxpayer” being based on the definition of a UK taxpayer, according to rules of UK tax residence. That Scottish taxpayer “subset” could then be altered by UK decisions, taken at Westminster, on the definitions of UK tax residence, decisions not taken in Scotland and subject to potential ongoing change, albeit that the changes may only affect a relatively small number of taxpayers.

Perhaps those rules aren’t ideal, given that the latest UK consultation process is being extended due to issues with the complexity of the proposals and their impact19. Do other international regimes provide the answer?

For companies, is it just Scottish incorporated companies, or any companies with places of business in Scotland, or selling to or from Scotland which should pay tax in Scotland?

Whether a company is incorporated in Scotland or England and Wales has had so little impact in recent years it has been a decision of administrative convenience at the time of set-up rather than of import or consequence for the vast majority. The place of business rules might be expected to dominate.

For international businesses - which would then, by definition, also include those who do business inside and outside Scotland but within the UK - this area is fraught with complexities in compliance. Tax jurisdictions across the globe try to make sure they have their fair share of taxing rights; through defining who pays tax, and also what will be taxed in each tax regime – known as the transfer pricing issue. Each tax jurisdiction demands proof that transfer prices have allocated fair profits and tax to the appropriate exchequer, so the administrative consequences of these rules for businesses operating across the UK could be significant and result in an increased compliance burden. ICAS expressed its concerns on this matter in representations submitted in 201120; subsequent comments have been in relation to the balance between any advantage of a lower tax rate against the disadvantage of a greater administrative burden for all.

Beyond that, a number of key exemptions are granted in different tax systems, commonly for organisations such as charities (including schools and universities). Focussed exemptions are also given to particular types of income; these vary from miners’ free coal, to employees’ Christmas parties (within limits) and asbestos compensation, from electricity micro generation to players in the UEFA Champions League Final 2011. The list of reliefs

examined by the Office of Tax Simplification in its March 2011 report identified 1,042 in the UK tax system although a small number (less than 50) mainly of limited use or expired, have now been removed. In comparison to the existing system, there is no doubt that simplification could be achieved. The Office of Tax Simplification reports about reducing the complexity of tax reliefs and interactions within the system could also be read as a list of “things to avoid putting on the blank sheet of paper”, but also demonstrate the consequences in a tax system of trying to do too much for too many different interests. Which leads to question 4.

Question 4 - What should be taxed?

Probably the most fascinating of all questions relating to this matter, as it really includes separate issues of the tax source (the activity, such as earnings or profits, ownership of capital or wealth, consumption), the taxable amount (the calculation of the earnings or profits, less reliefs or exemptions) and the tax rate(s). All of these separately and together are what makes a tax system, not just the tax rate.

This is also where the interaction of the principles becomes evident. For example, if one chosen principle for the tax system is simplicity, then the system design would have simple rules for taxable activity – such as all earnings, profits, gains, pensions – then apply one of the simplest taxable amount calculations – the cash receipt – and tax rates would be a simple fixed and flat percentage.

But if another chosen principle is that a fair tax system should be based on ability to pay, then a simple flat tax rate does not deliver that; progressivity of higher tax rates for higher incomes and greater affordability would be demanded.

Why is the existing UK tax regime so much more difficult? A simplistic answer is because of legislative baggage, because cash receipts can be manipulated - if your employer pays your rent directly to the landlord, whose taxable receipt is it? - and are not currently regarded as giving the recognised measure of the net economic or business performance or health. However, the possible use of cash receipts and other simpler approaches for smaller businesses are now the subject of an HMRC consultation, following a review by the Office of Tax Simplification and the Department of Business, Innovation and Skills; their research and observations will be informative in this debate.

Radical outcomes might be possible and practical. The UK system currently has separate systems for taxing investment income and capital gains, once realised. The rules are lengthy and complex. Other countries have tax systems based not on realised income and capital gains, but a deemed return on invested capital; the Netherlands for example taxes an annual 4% deemed return on relevant wealth; ability to pay is simply assumed and the compliance burden much less. Some of the alternatives to consider based on other jurisdictions’ practices were set out in the Office of Tax Simplification report referred to above.

22 HMRC “Simpler income tax for the simplest small businesses” March 2012
23 The Office of Tax Simplification “A simpler income tax for the smallest businesses; a discussion paper” July 2011
25 The Office of Tax Simplification “A simpler income tax for the smallest businesses; a discussion paper” July 2011
Would, or should, inheritances be taxed? Many estates now involve trust arrangements (a trust being a legacy of protection of land and wealth in past generations, perhaps as far back as the Crusades) and a large proportion of the tax code deals specifically with this area. Is it worth looking again at this for the Scottish taxpayer base? Much value is still held in the form of land, on which a transfer tax (stamp duty land tax) is currently payable. What about a simpler, combined approach to taxing these?

This also leads to the question of what activities or groups should be favoured, or otherwise, in the ideal tax system. Do we continue the UK system of favouring entrepreneurs on capital gains and inheritances on the basis that they are employment creators and should be incentivised? Certain types of growth-related activity, such as research and development, often gain support, but again we get back to principles. If economic competitiveness is a key principle, does that mean favouring particular sectors or activities, and which ones, and how? Usually this means adjusting the tax base (the taxed profits) rather than the tax rate, but international tax competitiveness is an ever changing field. Any government needs to make sure that the form of any tax rate or tax base reductions do result in economic growth and so tax yield replacement, rather than a permanent loss of tax revenue without any benefit.

With an ageing population, could Scotland afford to continue the more generous personal allowances for the over 65s, particularly if there is tax relief given on pension contributions – even taking account of the recent Budget announcements? With the challenge of getting school-leavers into work is it worthwhile improving their chances of being employed by giving them and their employers’ tax breaks, or more relief for training costs? Is it time to integrate income tax and national insurance contributions, which might highlight that earned income is more highly taxed than unearned income, and taxed according to different rules? This is not to discuss mainstream party politics but to suggest how wider consideration in our blank-sheet-of-paper world may highlight some different approaches needed for the 21st century.

William Pitt in 1796 presided over taxes on dogs, windows and male servants. Recent calls have been made for taxes on carrier bags, cyclists and tourists. ‘Who pays?’ is always difficult to answer and exercises many minds; popular consensus on this may take time.

It is also necessary to consider taxpayer behaviour, and the behavioural response to tax legislation and changes. Most people don’t like paying tax. Most people will try to avoid paying tax, mostly within the law (tax planning or avoidance) but sometimes outside it, through tax evasion. So whilst you can design any tax system you want, it needs to be workable and collect what you want it to.

This means mechanisms to pursue tax evasion and address tax avoidance; a strong compliance and enforcement regime penalising evasion may be needed. For tax avoidance, the decision is about what behaviours to tackle; where is the line between acceptable and unacceptable tax planning? Another principled debate is needed here for the tax system to be designed, with contributions no doubt from informed sources such as Graham Aaronson QC’s Study Group report on anti-avoidance legislation26.

Finally, there is the geographic question, particularly for businesses operating overseas as well as in the UK. Does the system aim to tax profits generated in Scotland, or owned by Scottish companies, or use another approach? The UK is at present party to a number of

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26Available from [http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.PDF](http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.PDF)
international tax agreements, which, according to the Organisation for Economic and Social Development’s principles, determine the jurisdiction with taxing rights over property or income, and of relevance to companies and individuals. Territoriality has become the emerging theme for the taxation of international business groups globally. Whether some protest groups like it or not, the UK and many other jurisdictions permit, indeed have rules designed to facilitate, an acceptable level of tax planning internationally. Should Scotland sign up to the same principles of territoriality and network of double tax treaties independently? Would this be an absolute necessity in order to gain the tax efficiencies they deliver for businesses located here, such as not having a cash-flow disadvantage from suffering withholding taxes, which is key to competitiveness, and being an acceptable, never mind attractive, business location. Is there a credible argument for taking sectoral favours further and adopting tax haven status for money box companies based here, as is the case for other small jurisdictions such as the Channel Islands? How would the EU view that?

The shape of tax systems changes whichever jurisdiction is reviewed, but each needs to be seen in its entirety, rather than piecemeal. This is probably a matter where learning from overseas systems could be most informative.

**Question 5 - Who should run any new tax system in Scotland?**

Once the tax system is designed, the administrative resource can be aligned accordingly. Even more decisions are then needed; what accountability should there be of that resource to the Scottish Government? Recent examination of HMRC by the House of Commons Public Accounts Committee has revealed gaps in expectations of governance, never mind scrutiny, of the HMRC Board; the outcome of the current Cabinet Office review might be informative. But with Scottish Parliamentary procedures and principles already in place, how would these be built on to achieve the types of performance management and accountability that a tax authority might be expected to deliver?

The UK tax system is run by HMRC, based on massive IT systems developed over many years. Would a devolved tax system require a new Scottish tax administration to be established or would it be outsourced to HMRC? What would it cost and how long would it take to establish? With a largely England-based technical division, and following recent reorganisations, HMRC has arguably neither the expertise nor capability to staff a Scottish Tax Administration without major re-engineering. HM Treasury and London based HMRC staff currently drive the majority of policy decisions; the current HMRC staff in Scotland do not have the range of policy and management experience, nor operating structure, to operate a separate tax system at this time.

This question was identified in the Scottish Government paper last year27 but perhaps the question would need to be addressed with a specific design in mind. If an outsourcing approach is considered, why limit consideration to HMRC; why not consider, say, the Australian administration, which on some National Audit Office analysis seems to operate with greater efficiencies28? Bear in mind also the potential lack of economy of scale in a tax system run for Scotland, at less than 10% of the size of the UK; a different cost-effectiveness and efficiency model from that for the UK may be desirable to achieve value for money.

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Question 6 - What would be needed to implement any tax devolution in Scotland?

This is a bit of a chicken and egg dilemma; until the process of designing a tax system is complete, including who should pay tax and on what, it is impossible to know what it will yield and therefore whether it will achieve its economic tax raising purposes. The data that might be needed to prove economic effectiveness, such as statistics for the Scottish taxpayer base of individuals and businesses, is not held by anyone at present; for the simple reason it has never been, nor had to be, collected. A significant data-gathering exercise seems on the horizon if there is to be any tax devolution, as well as extensive economic and behavioural modelling exercises. The Barnett formula impact debate may use or provide some of this data as well.

Then there remains the need to identify the Scottish taxpayer base. How? There are no complete, tax-system-ready records of who is in Scotland at the moment (if that's the tax base you decide). HMRC can select details according to postcode but only for those “live” on the system, and there are serious concerns over data accuracy. Reporting of address changes, immigration and emigration render this an ever moving target. The issue for companies was set out above – there is a less immediate linkage of taxable profits to postcodes, given businesses may have many offices or depots – so that exercise too is needed to decide which companies and what proportion of business profits would fall within a Scottish tax net. The compliance burdens and competitiveness impact were outlined in ICAS representations in summer 2011\(^{29}\) and addressed at page 6 above.

Any departure of all the Scottish taxpayers (once defined) from the UK tax regime would introduce the scope for potentially interesting negotiations with HMRC on handover matters, such as tax deferrals or exit charges from the UK tax system, as arise for those leaving UK tax residence. This may result in a requirement for the establishment of a separate tax administration for any devolved tax powers or jurisdiction, or some other mechanism to avoid “HMRC Scotland” arguing with “HMRC UK”; a situation commonly agreed to present quite a conflict of interest and accountability.

The tax provisions would then have to be passed into legislation, possibly a lengthy process of drafting and review. There are around 80 Acts of Parliament at present relating to UK tax and national insurance contributions with provisions in effect, not to mention a huge quantity of secondary legislation and guidance. The massive volume of existing legislation is directly related to the number of things the tax system is trying to do; the number of taxes, types of taxpayers, rates, reliefs etc – complexity – plus the drafting style of the legislation. That people just don’t like paying tax mean that a plethora of anti-avoidance provisions abound, not always very efficiently or effectively. Whilst in theory a different approach to legislative drafting might be taken with the blank sheet of paper system, it would be a drafting approach not yet developed.

At present it takes a UK Government at least a year, probably nearer two, to shape, draft and enact one Finance Act, so getting to grips with a realistic timescale for any tax devolution is essential, even once the Scottish Parliamentary processes and procedures have been decided. To design and implement an independent tax system in Scotland from scratch may realistically take at least a decade if not two, shorter if a more limited devolution of

powers is involved. Transitional provisions for taxpayers to move from the UK to any new system would also need to be considered, with decisions on changeover dates and records, and no doubt lots of forms to be filled in unless smart thinking is applied. Adopting the conclusions of the Mirrlees\(^\text{30}\) report might shorten this process, but only perhaps if it received wide support. It may be that as a matter of practical reality the decision is made to adopt the existing UK tax system with the potential for devolved changes over time, but that will defer, rather than avoid, this debate.

Good and clearly established relationships with overseas tax jurisdictions are key to business and economic competitiveness, through the operation of the Double Tax Treaty network as well as cooperation agreements. It is likely these would need to be established and maintained for a devolved tax system as well. Changes to tax systems do not necessarily cause the principles in Double Tax Treaties to fail, but what is the position of any change in the tax authority at the same time? Would any devolved or independent negotiating position be seen as weaker, being from a smaller and newer tax authority? A clear position on how any tax system changes would impact on business competitiveness in this area is an early requirement.

This final question is the one where practicalities and processes loom largest. Given the competitiveness agenda of most countries in economically challenging times, and the need for many for certainty in a world where uncertainty may be seen as risk, is it important that a process and timetable for this debate, or the destinations, are set out sooner rather than later? Or is time better spent in design and on principles? ICAS members welcomed the sentiments behind the UK Coalition Government’s Corporate Tax Roadmap in 2010, and would welcome continuation of those principles of a clear direction of travel. As stated above, this paper is about starting the debate on tax system design options in the light of the devolution debate. Much more will no doubt be written in due course on the practicalities.

But whichever tax future is chosen, there is likely to be agreement that it would be helpful to optimise the benefits of a chosen system and minimise the costs and adverse consequences of change - we come back again to an area where ICAS members contributions to the debate may be hugely valuable.

**The ICAS debate**

A basic tenet for this paper is that ICAS members have a contribution to make to the debate on Scotland’s future, its meaning and implications for those in Scotland, the rest of the UK and beyond. ICAS has a duty to act in the public interest, which means that we should contribute information and insights to the debate, based on the considerable interest and experience of our members in technical areas such as taxation, but including also pensions, governance and regulatory matters.

This paper is the first in a series that aims to do this; we are seeking to ask the questions in key areas that those on all sides of the debate should address over the coming months.

Members are invited to contribute their views on this taxation paper, the questions it identifies or those that should be added, deleted or altered. Written responses can be emailed to [tax@icas.org.uk](mailto:tax@icas.org.uk), preferably by the end of May 2012. After the initial round of

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member consultation and debate, it is envisaged that wider events and discussions will take place later in 2012.

For the avoidance of doubt, ICAS will not be taking any political perspective or taking a stand for or against any referendum proposal.

11 June 2012
The Institute of Directors (IoD) and Confederation of British Industry (CBI)—Oral evidence (QQ 279-330)

Transcript to be found under Confederation of British Industry (CBI) and The Institute of Directors (IoD)—Oral evidence (QQ 279–330)
The Institute for Fiscal Studies—Oral evidence (QQ 823-843)

Evidence Session No. 17  Heard in Public.  Questions 823 - 843

TUESDAY 27 NOVEMBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Tugendhat

Examination of Witnesses

Mr Paul Johnson, Director, Institute of Fiscal Studies.

Q823 The Chairman: Good afternoon. This is the 17th public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. We are actually coming quite close to the end of our public hearings with witnesses. Mr Johnson, thank you very much indeed for coming. We are very interested in being able to discuss with you your splendid paper that you have provided on this subject. I ought just to warn that we think that we may have a Vote very shortly, so we will have to suspend for 10 minutes while we have the Vote. Is there anything you want to say at the beginning, or are you happy to go straight into questions?

Paul Johnson: I am happy to go straight in other than to say that the paper that we have published is very much the very first piece of work that we have done in this area, and we are planning a programme of work over the next year which may actually answer some of the questions that I know you have. If I cannot answer all of them, it is because quite a lot of them we are intending to answer but have not yet done the work on.

The Chairman: We would be actually be very interested to hear today exactly what that programme is that you have mind, and the general timing of it, but perhaps we can do that as
we go through questions. Could I begin with the first question? There are a couple of questions, actually, that I want to ask you first. Including a geographical share of oil and gas, you show in your paper that an independent Scotland’s fiscal balance as a share of GDP is slightly better than for the rest of the UK. Is this also true—this is the first question—as a share of GNP, as near as you can tell? I ask that because, as you will know, in the Ireland debt crisis it was the debt-to-GNP ratio which became the issue. That is the first question.

The second question is: is it also not the case that the amount that a country needs to borrow, whether this is high or low, depends on many issues such as track record in honouring debts, past records and so on? That also includes, of course, the rates of interest at which they have to do it; I have in mind in particular there, of course, that it is different for a small state that has no track record.

**Paul Johnson:** The answer to your first question is, as you will know—at least so far as we can find out—that there are no GNP estimates for Scotland. Our presumption of course is that GNP looks less positive in Scotland than GDP, in terms of taking into account oil and gas revenues, because a lot of that will not accrue to people in Scotland, so the net debt will look less attractive as a proportion of GNP than of GDP, and probably very similar to that of the rest of the UK. In terms of the annual balance, again, you will move including oil and gas revenues from a position which was a little bit better than the rest of the UK to one that looks a little bit more similar.

The issue of borrowing costs and other aspects is not something that we have yet taken account of, but you are right: clearly the amount of interest that would be payable might be different for an independent Scotland. It might be higher, which would make the overall spending position less attractive, and of course an independent Scotland would not inherit all of the credibility and history that the UK as a whole has got. But that is why, as we discuss later on, actually the degree of commitment that a newly independent Scotland can make to a particular fiscal stance may make a difference, at least in the medium run, to their borrowing costs. I would not like to speculate on what difference there would be in Scottish as opposed to UK borrowing costs within the first couple of years.

**The Chairman:** Does your answer to the second question mean that you are going to look at this further and possibly produce a paper further?

**Paul Johnson:** I do not think we will produce a paper which makes any estimate of what those borrowing costs would be, but we will be saying something about, within a plausible range, how much difference different borrowing costs would make to the fiscal situation.

**Q824 Lord Lawson of Blaby:** If I understand your answer to the last question, you were saying that, for very good reasons, the interest rate that an independent Scotland might have to pay to borrow on the capital markets would be likely to be higher than is the case for the United Kingdom at the present time, other things being equal. You also say in your interesting paper—an excellent paper—that there is a heavy dependence on oil and gas revenues, relatively speaking; and that oil and gas revenues are “very volatile”, in your expression, and that they are likely to fall, looking ahead to the future. Does that mean that in your judgment the present level of public expenditure in Scotland is unsustainable?

**Paul Johnson:** It must be the case that, at the point at which oil and gas revenues fall and fall significantly—exactly when that will be I do not know, but certainly the OBR is suggesting that within 20 or 30 years they will all fall to very small levels—if other taxes remain as they are, spending in Scotland will be more than would be sustainable given that tax base, because spending in Scotland is really quite substantially more per head than spending in the rest of the UK. Taxes outside of North Sea taxes are about the same as the rest of the UK, so if
you take away the North Sea revenues that is not a sustainable position into the long run
and, over the medium run, a Scottish Government will need to make some choices about
other tax revenues or about spending if it is to reach some kind of balance into the medium
to long run.

**Lord Lawson of Blaby:** So the choice then, looking to the medium to long term, is
between higher levels of taxation or lower levels of public expenditure.

**Paul Johnson:** The UK as a whole is clearly going to have to make that choice because of
demographic change. Scotland will have layered on top of demographic change the loss of oil
revenues and the fact that they start from a higher level of spending, relative to non-oil tax.
So, yes, there will have to be some choices as you describe, in terms of higher taxes or
lower spending than at present, although of course that lower spending need only take
spending levels down towards where the rest of the UK is.

Q825 **Lord Forsyth of Drumlean:** Just following on from that, on the basis of your
report, as the oil revenues fall away, the advantageous position that a newly independent
Scotland would have fiscally obviously disappears. When do you think the crossover would
occur, all other things being equal?

**Paul Johnson:** I am afraid that we have not made a calculation of that. It is clearly highly
dependent on what happens to oil prices and production in the North Sea, so I do not know
what year that will be. Again, that is one of the things we will look at in more detail—at
what the pattern of change will be over the next 20 or 30 years.

**Lord Forsyth of Drumlean:** Because your report does actually, throughout, make
assumptions that things will remain constant but, on this key point, you are not prepared to
speculate?

**Paul Johnson:** Our report says that in year one, assuming a geographical share of oil
revenues, things would look relatively better for an independent Scotland, but it also makes
clear that in the medium run that would change. We have not speculated on what point the
crossover comes in terms of oil revenues. What we have done so far is look at the snapshot
short term with a little bit of speculation on the long run.

**Lord Forsyth of Drumlean:** Will you be doing further work on this, because it is the key
thing?

**Paul Johnson:** It is.

**Lord Forsyth of Drumlean:** Some people, for example, have suggested that the crossover
would come as soon as five years, which would mean that the whole of the detail and
negotiations would not be sorted out before the money had disappeared down the plughole.

**Paul Johnson:** That may well be possible. The focus of our final report will be very much on
the medium to long run, because there is a sense in which day one is much less interesting
than the rest of time—

**Lord Forsyth of Drumlean:** Unless you live in Scotland.

**Paul Johnson:** —so we will be focusing further on that.

Q826 **Lord Levene of Portsoken:** In the financial services sector, do you think that an
independent Scotland would try to introduce different corporation tax levels from the rest
of the UK? Would independence mean that tax relief could not be claimed on one side of
the border for losses made on the other side? Do you think that would be an important
issue for companies in that sector who have headquarters north of the border but carry out much of their business—perhaps the majority of it—south of the border? Is there not a risk that the tax paid in Scotland, if that were to be true, would be a lot lower than the estimates you have made?

Paul Johnson: I could not speculate on what will happen to corporate tax rates. I certainly understand that there is some thought being given to that as a way of making Scotland more attractive for investment. The short-term consequences of reducing corporate tax rates in a country like Scotland will almost certainly be to lower corporate tax revenues. The much longer-term consequences are much harder to judge. In terms of how companies which currently operate across the two countries are taxed, I imagine that will be one of the very many parts of the negotiation that will be had between the two, but the default, I guess, will be to treat them as if they were two entirely separate countries, as the UK and Ireland are at the moment. My understanding then is that in most circumstances you are not able to offset across borders in the way that you describe.

Lord Levene of Portsoken: As you say, you cannot speculate on what the level of tax would be, but equally I do not think that you can assume that it would not change.

Paul Johnson: No, and we would not assume any such thing.

Lord Levene of Portsoken: It would be difficult to think that they would want to increase it, because it would make it even less attractive to be there. So, as I said, if the level comes down the absolute intake of tax in an independent Scotland would fall quite a lot.

Paul Johnson: Clearly, if you reduce taxes, then the amount of tax raised would go down.

Lord Levene of Portsoken: And from what you have seen, do you think that the Scottish Government have taken that into account—the possibility that the revenue may come down substantially?

Paul Johnson: I really do not think I could comment on that. The broad economics tends to be that, if you are a country as Ireland was 30 years ago that has a very small corporate tax base and you introduce a very low corporate tax rate, then you are probably doing a lot of good for the economy and probably for your corporate tax revenues. Scotland actually has a tax base which is not dissimilar, again in the corporate sense, to the rest of the UK, so reducing the corporate rate would—as it would in the rest of the UK—at least in the short run reduce the amount of revenues that come in. That would have to be part of the calculation that a Government would make.

Lord Levene of Portsoken: But the proportionate value of the financial sector in Scotland is actually quite high, particularly when you look at the number of large firms in that sector who operate right across the UK with a relatively small part of their business in Scotland but actually with their operation based in Scotland. So if they remained as a Scottish company and that came down, which it would have to do, given the rest of the economy, presumably it would hurt them quite a lot.

Paul Johnson: On a simple arithmetic basis, if you reduce the rate, as I say, by five percentage points—by 25%—you would expect in the short run the revenues to fall by an equivalent amount.

Q827 Lord Rowe-Beddoe: Your report on defence spending suggests that it would not qualitatively change the whole picture, even though the policy itself in this area may change in future. We have had some very differing opinions about what may or may not happen with regard to the actual disposal or otherwise of Faslane and so on. Other witnesses have
told us that many thousands of jobs could be directly or indirectly affected. I wonder if you had taken that into your calculations for your report.

Paul Johnson: The statement we made in the report was really intended to dispel the idea that you could get rid of, as it were, or very significantly ameliorate the big “spending per head” difference between Scotland and the rest of the UK by, for example, halving even the amount of defence spending as a proportion of national income. So if Scottish defence spending were to be halved as a proportion of UK defence spending, that would not qualitatively change our judgment. It would reduce spending per capita—I cannot remember the numbers—maybe by a couple of hundred pounds per head, not the £1,200 per head which is the difference. So the point of the statement was that you cannot get out of this difference by assuming anything different about defence spending. With respect to the question about jobs and the allocation thereof, that is not something that we have looked at at all at the moment, I am afraid.

Lord Rowe-Beddoe: But obviously you would consider that the impact of a substantial reduction in employment will ultimately have an effect upon your studies.

Paul Johnson: Clearly if the long-run employment rate—

Lord Rowe-Beddoe: But if it all moved out—

Paul Johnson: Clearly if the long-run employment rate turns out to be lower than it otherwise would, that would be bad for the fiscal situation. Again, as economists we tend to think that, in the long run, if one industry goes eventually another one will replace it. The question really is: how long is that going to take? So clearly, if an industry closes overnight in an area that is very dependent on it, then that has a very big impact socially and fiscally in the short run. If these things happen over longer periods in a more geographically dispersed way, then actually the impact fiscally may be much less.

Q828 Lord McFall of Alcluith: I am interested in that answer, Mr Johnson. I used to represent the area with the Faslane base, which had direct and indirect jobs of about 10,000. If that was getting taken away, that would have a bad effect for that area, but there are consequences for the strategic safeguards in Scotland, in that the west coast is not the place for an independent Scotland to have its main base: it is the east coast, given the oilfields, et cetera. There are implications, and I just want you to elaborate on maybe the domino effect here of that. Given that we have shipyards—BAE and others in Glasgow—and high-quality skilled jobs, is there a risk that if we start dismantling that it could have an effect on the manufacturing base and the quality of jobs in Scotland?

Paul Johnson: I am really not sure that I am qualified to comment in any detail on the specifics here. As I said, what we clearly have seen in the past is that where significant industries shut down very quickly, that can have long-term deleterious effects on the labour market and socially. Where there are other industries around, and particularly where these things happen more gradually, actually the impact is often much less than you would expect, and I am afraid that I really do not know the details of either what the world looks like at the moment or where a negotiation might end, in terms of what the jobs—

Lord McFall of Alcluith: Okay, you do not know the details and I am not asking you to, but do you think that would be an issue to discuss for the future?

Paul Johnson: If there is a significant source of employment and that source of employment were to end, clearly that will be an issue.
Lord Rowe-Beddoe: If you take another example of—Wales had close to a million people in the coal and steel industries at around the Second World War, and it took some 40 years actually to begin to replace those jobs. That is the sort of long-term effect; although you say short-term. It was not until the 1990s that employment was getting anywhere near to the UK average.

Paul Johnson: Yes, you see the mark of history everywhere. Wales remains a very, very much poorer country than Scotland or indeed the rest of the UK, and it is clear that there are parts of the north of England that are still suffering from closure of pits and other bits of heavy industry decades ago. I certainly would not suggest that these things do not persist over long periods. Equally, there have been really big changes in the structure of employment in other parts of the country, and that has not had that kind of effect. Very often the detailed picture of what has been happening, the extent to which things are happening across different industries at the same time and the degree of dependence on particular industries all interact to determine the long-run effects.

Q829 Lord Hollick: In your very helpful paper, and indeed in your responses to earlier questions, you have made plain that there will be, over a period, a potentially significant squeeze on the public finances of an independent Scotland as a result of declining oil taxation and increasing cost of the aged population, and all that against a background of higher expenditure per head anyway. The question of the crossover point seems to me an interesting one, because it may be that the crossover point is actually at the start, because financial markets are going to be able to spot this pretty straightforwardly, as you point out in here. Therefore, what we might describe as the fiscal sustainability—the credibility—of Scotland as an independent borrower in markets to finance its own public debt may actually require a clear sense of direction and clear sense of how it is going to tackle the squeeze on public finance at the outset, let alone in five or 10 years’ time. So will you be doing your usual scorecard and look at this particular argument in the context of the referendum, and say, “Here are the choices” without necessarily offering one as the solution? Will you be doing that kind of rigorous analysis so that the voters in Scotland have a clear idea of the options that an independent Scotland would have to consider in order to sustain financial stability and the ability to borrow in the international markets?

Paul Johnson: I do agree with the premise of your question, which is that it will be very important for a newly independent Scotland to have a very clear fiscal framework and plan for dealing in the medium run with what will, in any case given what is happening in the UK as a whole, be a difficult fiscal situation and one, as you say, in which they will need fairly rapidly to make reasonably clear what the direction of policy will be in the face of declining revenues. I have to say that, while this will be difficult, a lot of countries because of demographic change and the hangover of the current recession will be facing also difficult transitions. I would not want to make out that I believe that this is qualitatively, massively more difficult than a lot of countries will face. Clearly an independent Scotland can cope, but it really will need to make some difficult choices—there is no question about that. In order to maintain credibility, it will need to be clear about what those choices look like and how it is going to tackle them.

In terms of the work that we do, as I say, I hope that what we are able to do is give a sense of where the fiscal arithmetic is taking an independent Scotland, and therefore within that you put a bit more scale and flesh around the choices that will have to be taken over a period of time. Exactly what that period is, I do not think that we have yet determined. Hopefully that will give a sense of what are the types of choices available, and illustrate how
much a change to the VAT system, the income tax system, spending on long-term care or whatever—different bits of the tax and spending system—can help.

**Lord Hollick:** It is hard to believe that one of the options would be a reduction in corporation tax.

**Paul Johnson:** As I say, that is a fiscal choice that could be made. Let us be clear: this Government are significantly reducing rates of corporation tax while going through a very significant fiscal squeeze, so it clearly is a choice that is open, but of course if you do that you have to squeeze other stuff harder. That is what this Government have chosen to do, and in the face of international competition we may see lots of Governments across the world doing that.

**Q830 Lord Lipsey:** Following on that side and concentrating for a moment on the spending issues—I know you say that you are going to do more work on this—on page 12 you raise two of them: namely what you call free personal care, which is an acceptable shorthand, and education. If I could just focus on free personal care for a moment, is it not the case that spending on free personal care in Scotland has doubled in real terms since the policy was introduced in 2002-03?

**Paul Johnson:** I do not have the numbers to hand, but that sounds right.

**Lord Lipsey:** When the Chief Secretary to the Treasury came before us, he made the very interesting point that dependency ratios in Scotland will deteriorate dramatically, in the sense that the proportion of elderly people in the Scottish population is going to increase greatly relative to the rest of the UK population. Assuming he got that right, does that not lead to another difficulty in that area? You have got a fast-ageing population and a fast-rising source of expenditure.

**Paul Johnson:** Yes. Again, I do not have the precise numbers, but it is the case that, on current ONS projections, Scotland will be going through a more significant ageing process than the rest of the UK. Of course, this is terribly dependent on all sorts of assumptions, including fertility and migration and all that kind of stuff, but that is what the official figures at the moment suggest. As you say, the way in which long-term care is currently funded in Scotland makes that more expensive and likely to grow more quickly—though, if any of the reforms that the Dilnot commission or others, or indeed your previous commission, suggests are implemented in the rest of the UK, then the rate of change will actually be bigger in the rest of the UK. There is a reasonable school of thought which says that the current situation cannot persist for ever, which would lead to at least a proportionately faster increase in spending here, though from a lower base and to a lower level, assuming that policy stays as it is in Scotland. But, yes, clearly, in the face of an ageing population, current policies put more pressure on the Scottish budget.

**Lord Lipsey:** What you say is quite true, but that is a problem for the UK as a whole. If Scotland goes independent, there is a problem solely for Scotland, because they will not expect the rest of the UK to pay for their ageing population, whereas under the present system you would expect us to take a share of paying for their system. Therefore, really it is hard to see that the free care situation there will not come under tremendous pressure if they opt for independence. It would not necessarily be as acute if they did not opt for independence.

**Paul Johnson:** The acuteness of that choice, and many other choices, will likely be greater under independence, because that choice will have to be taken within Scotland. That is a tough choice that would be one of many that they would need to take.
Lord Lipsey: So are these things that you are hoping that your further paper which will cover these aspects will provide guidance to people in Scotland as to what is likely to happen?

Paul Johnson: I hope that we can provide more detail than we have at the moment, certainly.

Q831 Lord Shipley: Can I just pursue that point, because the paper that you are going to produce—I understood you to say in about a year’s time—will come just before campaigning starts for a referendum. I would like to be clearer what it is that you plan for it to contain. We have talked about the scorecard; you have talked about a Scottish Government needing to have a sense of where the fiscal arithmetic is taking Scotland; and in your written submission you talk, at the very end of your conclusions, about you—I think you—setting out and quantifying choices in the Scottish context. I would just like to be clearer what all this actually means. Do you have a list of those areas—those subjects—that you are going to do further work on, because clearly you will be publishing it at a point that will be critical in terms of a campaign starting?

Paul Johnson: I do not have a comprehensive list, because this will inevitably develop as we work, but let me try and set out what we are intending to do in broad terms. The core of it will be to look at the long-term fiscal situation in Scotland, over a period up to 2040 or perhaps 2050, in a way consistent with the way that the OBR has looked at these things for the UK as a whole. What would the situation in Scotland look like, and what would it look like on different assumptions both about interest rates that an independent Scotland would face and different assumptions about the rate of loss of oil revenues? That would be the kind of framework that we would be looking at. As I say, I think that is crucial, and more crucial in a sense than what things look like in day one. Then, within that, we would be looking at some specific elements. What are the type of choices that an independent Scotland would have over the structures of its tax system? What are the type of choices an independent Scotland would have over the structures of its social security system? And what are the choices that it would have in two or three other areas of spending where we know that they have, up to now, made significantly different decisions to those made in the rest of the UK? Then, sort of directly related to all of that, we will try to map out the different types of fiscal frameworks within which they might want to make those decisions, but ones which would make it reasonably clear, over a period, what the types of choices are that would need to be made in an independent Scotland. What we would need to be very careful to do, though, is to put those in the context of the quite tough choices that the UK as a whole is going to have to make over that period in any case. In previous work that we have done and the OBR has done, we know that the ageing of the population in the UK as a whole is going to create some pretty difficult choices, so we will try to compare those. That is our broad plan. The reality of the final document may not answer all of those questions, but that is where we are aiming for.

Lord Shipley: Okay. Let me then just raise a detailed technical issue around whether Scotland would have to establish its own revenue and customs authority. If so, given the complexity of tasks that it would deal with, such as licensing for oilfields, cross-border apportionment and tax enforcement issues, do you have any estimate of how much such an infrastructure might cost?

Paul Johnson: I have got no such estimate. I have no sense at all of that; I am sorry.

Lord Shipley: Right, but might you do some work to assess how easy it is to acquire the necessary expertise to run a separate revenue and customs authority?
Paul Johnson: I doubt we would be able to do work on that at that level of detail. I do not think that is a level of detail that we would be able to get into. My guess is that there would be a transfer of some staff voluntarily or otherwise from those who are no longer required by HMRC to do it, but I do not know, and I do not think that is the level of detail we would be able to achieve with the resources that we have.

Lord Shipley: But you would be able to talk about how an independent Scotland might inherit debt? On the actual system, in terms of the issue of bonds—some UK bonds, some Scottish bonds—have you done any work as to how that would operate?

Paul Johnson: No, not in that way. We would be again looking perhaps in a little more detail than we have at the choices that might end up being negotiated over in terms of the level of debt that would be inherited, but exactly the form that that debt takes is probably beyond the scope of what we will be doing.

Q832 Lord Tugendhat: You steer very well clear of any discussion around the currency issue. Obviously that is going to be central to a great number of the assumptions one makes about Scotland. In fact, one of the things that has come over very clearly from such industrialists as have appeared before us is the importance they attach to the integrity of the single market in the United Kingdom, of which the currency is clearly a part. In your report, you conclude that an independent Scotland would “inherit a debt-to-GDP ratio somewhat smaller or similar to that faced by the UK”. Even on the now optimistic OBR assumptions, that will be 75% of GDP. Is not that kind of assumption critically dependent on what currency Scotland should choose to have? If it were to have sterling, that is one way round, and if it were to go into another currency that would be another. What are you assuming about the currency and why, if I might ask, are you not more explicit about currency matters?

Paul Johnson: I am not entirely sure I follow your question. In a sense, obviously the currency is going to be a crucial decision, but I do not think I understand why it would be crucial to that particular calculation.

Lord Tugendhat: Well, I think it would be crucial to a lot of calculations, but presumably you have based that calculation on an assumption about what currency Scotland would be using, but you do not state what that assumption is.

Paul Johnson: I am not clear I understand why that depends on the currency. A huge amount of this depends enormously on the currency, but I am not sure why that does.

Lord Tugendhat: Okay. If you do not think it does depend on the currency, that is the answer.

Paul Johnson: I may be wrong, but I do not think that it does. The way that we did the calculation was essentially to say that if you allocated current UK debt on a per capita or per capita GDP basis, which is essentially the same, then that debt as a proportion of Scottish GDP would look very similar to the debt as a proportion of UK GDP. If that were allocated and the Scottish currency depreciated by some significant amount relative to the pound, that might change one’s view of it, but we are not basing it on an assumption about a change in the value of the currency.

Q833 Lord Lawson of Blaby: May I put what I think lies behind Lord Tugendhat’s question to you more directly? Clearly, one of the most important choices that a newly independent Scotland would have to make is the question of which currency to have—whether to try to piggyback on the pound sterling, whether to gain access to the European
Union and join the euro, or whether to have its own independent Scottish currency which was free to float, say. These are quite important considerations. You say nothing about this or its implications in the report that you have done so far. Can I take it that you will be doing so in the follow-up report that you have told us you are about to produce?

**Paul Johnson**: I agree with you that this is an absolutely crucial issue in terms of the way that an independent Scotland operates, but actually these monetary issues are outside of the scope of the work that we intend to do. I think Angus and his colleagues at the national institute will be looking more at the monetary and macroeconomic issues in the way that you describe. We can think about the consequences of different choices for some of the fiscal outputs, but that is not the core of what we are doing, and it is not part of our core competence, I am afraid. I do agree with you—it seems to me absolutely crucial—but the work that we are doing is part of a broader programme of work which is Economic and Social Research Council-supported, including some support for some work in the monetary and macro areas.

**Q834 The Chairman**: If Scotland were to become independent, then it would become a relatively large exporter of oil overnight. Presumably that would put some upward pressure on domestic prices. Do you think there is a risk of a sort of Dutch disease effect, which often has unintended consequences for countries which suddenly become resource-rich?

**Paul Johnson**: Again, it depends how that plays out. Given that we will start with a situation in which it is known or expected that this will be falling relatively quickly and where there is not a kind of big fiscal surplus, that may, to put it mildly, be less of an issue. Going back to the issue of currency, there is an interesting issue here about what a Scotland with sterling would look like, given the very large role that oil plays. You would clearly have a situation in which you have got the same currency as the rest of the UK where external shocks to oil prices are going to have very different effects on Scotland and the rest of the UK, and there might be some risks in that. There are clearly examples, including Norway, where there has not been a massive suffering from a Dutch disease in the way that there has been in other places, so it also depends to some extent on how those revenues are used. Again, I do not have a strong view on that.

**Q835 The Chairman**: On a different subject, we have had a number of witnesses talking to us about the relative levels of productivity and entrepreneurship in Scotland compared with the UK as a whole. You have done a lot of research on the labour markets in the UK. Is your view that the labour market in Scotland is more or less flexible in terms of mobility and wages than the rest of the UK?

**Paul Johnson**: I do not know. It is clearly somewhat different. It is certainly different in the sense that the wage dispersion is more compressed in Scotland, particularly at the top end. It is somewhat different in the sense that there is, particularly in some areas in the west of Scotland, significant dependence on benefits. It is also itself quite differentiated in different parts of Scotland; just as within the UK, for example, the public sector plays different roles in different parts of England, so it seems to play quite different roles in different parts of Scotland. At the moment, I could not say that I think that the Scottish labour market is a whole more or less flexible than it is in the rest of the UK. We will look a little at some of the labour market issues. I know again, within the ESRC programme, Professor David Bell at the University of Stirling will be looking particularly at labour market issues.

**The Chairman**: Will you actually be doing a study of it and producing a paper, then, in the coming year?
**Paul Johnson:** We may collaborate with Professor Bell to look at some of that, but we are not specifically going to look at the degree of labour market flexibility north and south of the border.

**Q836  Lord Lawson of Blaby:** In your paper, you say, “The crucial unknown would be whether the financial markets might assess risk differently and thus raise the cost of the borrowing”. This is the sovereign borrowing by an independent Scotland, given the dual risk that, first, they have no established track record; and, second, that they have this volatile and declining source as one of their major revenue streams. You have pointed out that this does not happen instantaneously but, of course, not only are we not talking instantaneously but, as Lord Hollick pointed out, after a 2014 referendum there is bound to be a considerable period of negotiation and discussion, so we are looking some way out. Then we are talking about the financial markets, and the financial markets do not just look at the position today. They take a view, rightly or wrongly, of what lies ahead in the immediate future. Factoring all those things in, will you be in your new paper making some estimate of how much the cost of borrowing will be raised?

**Paul Johnson:** Certainly we will be looking at different scenarios for different costs of borrowing, and I think we will be looking at the experience of other countries. I think we will not be saying that our view is that the cost of borrowing will be 3% higher or 1% higher or whatever it is than the rest of the UK; that is beyond our capacity to forecast, but we will look in more detail at the things that are likely to determine it.

**Lord Lawson of Blaby:** If you will not be saying that, what will you be saying?

**Paul Johnson:** As I say, we will be using different scenarios for different costs of borrowing to look at the different fiscal situations that Scotland might be in. We can look at the range of different borrowing costs that different companies in different situations look at, but it is not something that we—the IFS—would tend to do, which is to try to make a macroeconomic-type forecast of that kind. That is not something that we have the models to estimate.

**Q837  Lord Tugendhat:** Just following up that question, I understand your reluctance to say that the cost of borrowing would be a given percentage greater or less than that of the United Kingdom, but in the light of your previous answers and in the light of the dependence on the volatile oil market, would I be right in assuming that the cost of borrowing would be likely to be more volatile than for the United Kingdom in its present formation?

**Paul Johnson:** I do not know whether it would be more volatile. The unknown here is not just what the policy outlook and framework of the Scottish Government will be in 2018 or 2020, or whenever one gets past the negotiations. One does not even know what that will be in the UK as a whole. One can imagine a Government which is less fiscally austere than this one, which might result in higher borrowing rates but a different balance between short-term and long-term growth from the current Government’s. How that will relate six or eight years out is very hard to estimate. It is clear that there will be underlying pressures on an independent Scotland that will be more significant than those in the UK as a whole. Also, an independent Scotland would not have the long history that the UK as a whole has. Those two things, you would think, would be pushing in one direction, which is why developing a very clear, transparent and credible fiscal framework very early on is going to be absolutely crucial to an independent Government. How successful it is in doing that will be one of its first and most important tests.
Q838  Lord Lawson of Blaby: If I can draw you out a little bit, you say that it has to be a clear fiscal framework. Surely it has to be not merely clear but cautious. If it were clear but profligate, that would not be an enormous help, would it?

Paul Johnson: I agree entirely. We will think more through what that framework will look like, but certainly a good starting point would be to think of a fiscal framework that, ignoring oil revenues, is aiming over a period longer than five years, almost certainly, towards some kind of cyclically adjusted current budget balance, equivalent to the one that we have in the UK as a whole. If you were to move in that direction, you could immediately start talking about the scale of some of the changes that we were talking about earlier that would be required in order to meet that. That is one possible cautious and clear type of framework and we will do more to set out the alternatives around it. For example, there is clearly a framework built into agreements in the eurozone, which is a possible type of framework that an independent Scotland might look to. It might use something based on the current UK structure or it might use other ones. How it does that will clearly matter a lot, but I agree with you that caution is likely to be an important part of it.

Q839  Lord Hollick: You have drawn on the OBR’s macroeconomic model, part of which is its estimate that the low growth between 2007-08 and 2011-12 has not permanently but for a generation impaired—I think that this is the expression—the growth potential of the UK economy. Is there any evidence that the situation is different in Scotland, so that there might be room for a more optimistic, if not profligate, assumption? For instance, is there more spare capacity in Scotland? Is there any regional difference in the OBR’s assessment of the medium-term growth potential of the economy?

Paul Johnson: I am not aware that the OBR does it separately on a regional basis. We have certainly not looked at that, so I do not know whether there is any such evidence around.

Q840  Lord Levene of Portsoken: In terms of entrepreneurialism, the CBI has said that the number of enterprises per head, if you like, is much lower in Scotland than in England. Do you believe that independence would give a fillip and a great push to entrepreneurialism in Scotland, so that people will all be rushing off to set up new businesses there?

Paul Johnson: I do not know. I have really no view on that, other than to say that I think that, in the words of Lord Lawson, it would not be cautious to assume that that will happen.

Q841  Lord Rowe-Beddoe: Going on from that, would you be prepared to express a view as to what positive outcomes could accrue to an independent Scotland in this way?

Paul Johnson: I should start this by saying that a country in Scotland’s position can clearly economically and fiscally survive perfectly well inside or outside the United Kingdom, but, as someone who works on fiscal economics, it would not seem to me that that is the fundamental basis for any choice. In that sense, it is somewhat of a surprise that this appears to be such a central part of the debate. Where might the benefits lie? Well, the benefits might lie in the same place that they always might for a region or a country that is gaining more independence. It would be able to make its own choices over the way in which it raises taxes and the way in which it disburses those taxes; it would be able to take those decisions closer to the people who are affected. The UK tax system is not a perfect thing of beauty. An independent Scotland might be able to turn the tax system into something less horrible than that which we have in the UK. The same is true of many aspects of non-devolved spending, including the social security system. It gives an independent Scotland choices and the ability to make those choices in ways that may be more attractive to it. It may well be that the Scots people have a different trade-off between the level of equity that
they want as opposed to the focus on economic efficiency one way or the other. They may have different views about the appropriate levels of benefits for pensioners or people out of work and so on. The key advantage comes in being able to take decisions in a way that is unfettered by the larger entity. The key advantages and disadvantages may come from the economics, but they are much more likely to come from the choices.

**Q842 Lord Tugendhat:** You use the word “unfettered”, and I think that I follow the drift of what you are saying, but surely in a number of ways they might be more fettered. In the first place, there is this dependence on a very volatile oil market, which is much more important to that economy than to the United Kingdom economy, so you have to plan around an element of considerable volatility. Secondly, if, as we understand to be the case, they wish to join the European Union, that carries with it quite a number of restraints, as we can see very well, in terms of taxation policy and in terms of debt and deficits and so forth. They may lose, in your language, one set of fetters, but it looks to me as if they might gain another set of fetters. I do not know whether the net result is a tightening or a loosening. I am using your language.

**Paul Johnson:** All independent countries are clearly fettered by what they can borrow. If they are within the EU, they are subject to the constraints of being in the EU. What I was really talking about was that they can choose the shape of their tax system and the shape of their social security system. They could choose to spend more and tax more, or spend less and tax less, in a way that within the UK they do not have the wherewithal to do at the moment.

**Lord Tugendhat:** What they do have in the UK is a certain consistency in terms of their revenue situation. It may not be as lavish as they would sometimes wish, but there is a level of consistency, whereas, with independence, whatever other benefits or disbenefits oil brings, it certainly does not bring consistency.

**Paul Johnson:** I am not quite sure what you mean by “consistency”. They will be forced to make a set of choices to live within their own constraints, but they can freely make those choices in terms of the level of taxation, the level of spending and the structure of that taxation and spending, as long as the two are not too far away from each other.

**Q843 The Chairman:** Mr Johnson, are there any other points that you would like to make to us that we have not covered already?

**Paul Johnson:** No, I think that that is a pretty thorough going over the territory that we have looked at thus far.

**The Chairman:** Well, I will take up the “thus far” point, because we are coming close to the end of our witness hearings—our last witness hearings on this inquiry will be on 18 December and, in the early part of next year, we will be producing our report. You have mentioned several times various papers that you might be producing over the course of next year. It would be very helpful if you could let us have, in so far as you have it, a list of the topics and the likely timetable of your publishing them.

**Paul Johnson:** I do not have a precise set of times. We hope early in the year to put into the public domain a more detailed analysis of the plain fiscal and economic facts—what Scotland looks like relative to the rest of the UK. At the end of the period, we will certainly have a detailed analysis of the long-term fiscal situation. Either in the period in between or in a final document at the end, we will have something that looks in more detail at some of the particular tax and spending choices, but, if it would be helpful, I can, once we have a clearer
timetable in mind, let you know. I should say that we were formally made aware that we had
the funding to do this only within the last month or so, so we have not made a great deal of
progress towards the details of it all. Indeed, the funding does not formally start until next
month, so we are not yet formally on that journey.

The Chairman: In so far as you can, it would be helpful to have it. Meanwhile, thank you
very much indeed for your appearance in front of us today and for the paper that you have
done.
Institute for Public Policy Research (IPPR North), Professor John Simpson and Professor John Tomaney—Oral evidence (QQ 244-278)

Evidence Session No. 5.       Heard in Public.       Questions 244 - 278

TUESDAY 19 JUNE 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Hollick
Baroness Kingsmill
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord McFall of Alcluith
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witnesses

Ms Katie Schmuecker, IPPR North; Professor John Simpson, Economist (Northern Ireland); and Professor John Tomaney, University of Newcastle.

Q244 The Chairman: Good afternoon and thank you very much for coming. Our witnesses today are Ms Schmuecker from IPPR North, Professor Tomaney of Newcastle University and Professor Simpson, an economist from Northern Ireland. Clearly, some questions will be relevant to the north of England, some to Scotland and some to Northern Ireland. Please answer when you think that they are of relevance to you, but some will be directed specifically. I will begin by asking a question that comes in two parts. Can you describe to us how the wealth and economic activity in Scotland and the north of England compare? In what ways are they similar and in what ways are they dissimilar?

Professor Tomaney: If we had been asked that question in the 1970s, we would have said that Scotland's performance and that of the north of England were quite similar. But since that period, if we take a broad measure such as GVA per head at a regional level, we see a
marked divergence between the performance of Scotland and that of the north of England, particularly a region such as the north-east of England. In terms of GVA per head, from the end of the 1960s onwards we see London and the south-east of England pulling away from the UK average; we see the northern regions declining in relation to the UK average; and we see Scotland, from about the 1980s, performing around the UK average. So the gap in percentage terms in GVA per head between a region such as the north-east and the south-east is something like 40 points, whereas Scotland is around the average. There has been a divergence in economic performance both between London and the south-east and the rest of the country, and also between the north of England and Scotland, in terms of that broad measure.

Ms Schmuecker: That is absolutely right. I will quantify that a little more. The most recent GVA per head figures that came out for 2010 showed Scotland at £20,200 and the UK at £20,400, whereas the figure for the north-east was £15,700. I have rounded the figures slightly. Certainly Scotland is performing at more or less the UK average, not just on GVA per head but also on other economic measures such as employment rates, unemployment rates and levels of economic activity. On all those measures, Scotland is near to if not at the UK average, whereas regions such as the north-east lag.

Q245 The Chairman: How would you describe the way in which the north of England and Scotland look at each other, and the degree of economic integration between the two? Is the north of England more integrated with Scotland than with the rest of the UK? In that context, would the economic cycles of Scotland and the north of England converge or diverge if Scotland became independent?

Ms Schmuecker: It is difficult to answer that question because the data that you would need are not readily available. Clearly there are areas of common sectoral interest. For example, in the oil and gas industry, the two economies are very interdependent down the supply chain. The central belt of Scotland depends quite heavily on the Port of Tyne and on Teesport for the export of goods. So there are examples of where the two economies are interdependent and intertwined. Certainly they have some things in common: for example, a slightly higher proportion of manufacturing in the economies of both places. To say how independence would affect that, one would almost have to get out a crystal ball; it is extraordinarily difficult to begin to disentangle some of these things. It would depend very much on what decisions an independent Scotland would take and what kinds of barriers might be established across the border between the two countries. So it is difficult to answer that question.

Professor Tomaney: I will add to that. If we were to compare the degree of integration between the north of England and Scotland, and the north of England and Wales, for instance, we would see that there was a much higher degree of integration in the case of the north-west of England and Wales. That is because we are dealing with a functionally integrated urban region with quite extensive overlapping travel-to-work areas. That is not the case in the relationship between the north of England and Scotland. On labour markets, for instance, the degree of integration is comparatively low. There are other functional forms of integration that Katie Schmuecker just mentioned. I agree with her that it is very difficult to predict what the impact of independence would be on the kinds of integration that exist between different regional economies. It would all depend on the extent to which a kind of jurisdictional competition emerged between England and Scotland in battles for resources such as foreign direct investment and so on. We have some insights into what that might look like, based on past and current trends. They may accentuate or intensify post independence.
The Chairman: I think that we may come to some of the issues that may affect that later in our questions.

Q246 Lord Tugendhat: Leading on from that, perhaps you could tell us what the sentiment of business in the north of England is towards the debate over Scottish independence. Is there any evidence that it is having any impact as yet on companies’ choices of where they locate? Is it having an impact in Northern Ireland as well? Is it in the front of people’s minds and influencing decisions, or is it something that people have not really faced up to in these two areas?

Professor Tomaney: My view on that would be—again, no research has been done on the question, so evidence is somewhat anecdotal—that in my discussions with business people, it has not emerged as a key priority. It is not at the forefront of the thinking of business people. They have many more pressing concerns on their minds in the current climate. Having said that, some business organisations have begun to think about these issues, and I think that they tend to see Scottish independence more in terms of threats than opportunities. That is my impression, based on discussions I have had with business organisations. But in a sense this is not being widely discussed by the man on the Newcastle equivalent of the Clapham omnibus. It perhaps gets a mention in the press.

There has been some public attention in relation to a small number of high-profile inward investment decisions taken recently that have favoured Scotland. I will give a couple of highly publicised examples. The decision of Gamesa to invest in a facility for the production of offshore wind turbines in Leith rather than Hartlepool, for instance, got a lot of attention. The other was the decision of Amazon to locate a facility in Scotland rather than in north Tyneside. That generated a degree of political and media attention, but it was very short lived. I have no idea whether these decisions speak of a larger trend or whether they are straws in the wind. It is difficult to tell at this stage. There have always been examples of investors choosing Scotland over the north-east, and there have been examples of the opposite. So it is hard to know whether this is a trend or whether it is just a couple of well publicised examples.

Q247 Lord Tugendhat: What about Northern Ireland?

Professor Simpson: I will provide some scene setting in answer to your question. At the moment there is a fear in the business community about the well integrated economy of these islands, which has been improving in integration terms over the past few decades. The fear is that that degree of economic integration will somehow fracture. The form this might take is now up for debate, with speculation about when Scotland might decide to act. Certainly there is an increasing awareness that this could become, in investment terms, more of a competitive relationship. Some business people would describe it as a situation where they would prefer it if the elements of these islands were not going to compete for who gets the biggest bit of assistance from whichever Government in whichever part of these islands. There is a fear of this split. We already have a very divided set of islands, with levels of devolution. The ultimate devolution was when the Irish south of the border went their own way. We have spent the past few decades trying to repair the border so that we have much more of an economically integrated island. The question is: is anything likely to emerge from this that will fracture the seamlessness of the economies of these islands?

Q248 Lord Lawson of Blaby: May I ask a supplementary question on that? You alluded to your experience of part of the United Kingdom gaining its independence right next door to you. Are there any lessons from that which you think might be of interest or relevance to
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the rest of the United Kingdom in the event of Scotland going the way that the Republic of Ireland did? If so, what are the lessons?

Professor Simpson: I think that the strongest lesson—I am not sure how widely this view is held—would be that the attempt following Irish independence to become a protective economy with protective tariffs and an “ourselves alone” approach turned out to be a mistake, as the Irish themselves would agree. But it took until the 1950s for that to be corrected. On the island of Ireland, we now have an agreement that the one thing we do not want to do is make the economy of the island more divided and fractionalised than is necessary.

Q249 The Chairman: Professor Tomaney, I would like to follow up on the question of Lord Tugendhat. I do not know whether you have seen the written evidence we have had from Newcastle international airport. It is quite short. They express obvious concern about the possibility in the case of Scottish independence of air passenger duty being very different from what it is at the moment. They analysed the risks of this and put forward a possible solution that I think is pretty unlikely. Their conclusion was that the consequences of such a move for the economy of the north-east of England would be devastating for jobs. I do not know whether that has had much publicity in the north-east. Lord Shipley may like to ask further questions about that. What is your reaction to that analysis?

Professor Tomaney: It has had a little publicity. The question of air passenger duty charges has had a huge amount of publicity in the region. It is probably fair to say that Newcastle airport has been one of the most vociferous opponents of increases in that charge. The argument is that it is a restraint on the competitiveness of Newcastle airport. They can provide evidence that some of their passengers come from Scotland to fly out of Newcastle. I think that their argument is a bit speculative, and that there would be European-level state aid restraints on what any Government could do in relation to this kind of competition. But you could envisage a situation in which there was a heightened degree of competition between, say, Newcastle and Edinburgh airports for the passenger market of the Lothians, and even for the passenger market in the north of England—people could travel north. That has to be set in the context of the complicated scene of airport capacity across the north of England. There are big questions about whether we have the right configuration of airports and so on. That would have to be brought into the mix.

Professor Simpson: Chairman, the issue that you asked about already exists in a very intense form on the island of Ireland between Northern Ireland airports and Dublin. The Irish Government have a passenger duty of €3 per flight, which is very small. The British rate applies in the same way to departing Belfast flights as it does to flights departing from anywhere here. The net result has been that the Treasury here has agreed that Northern Ireland should have the authority to set its own air passenger tax on long-haul flights outside these islands. Northern Ireland politicians argued strongly for that because of the distortion of trade from Belfast to Dublin, but one interesting thing is that the net effect is that it is becoming a Barnett formula-type question. If you are going to have tax authority yourselves, do not expect the Treasury to subsidise you if you then cut your rates. However, the intention of Northern Ireland politicians is to match the Dublin rates.

Q250 Lord Hollick: Did Gamesa or Amazon give any reasons for their decision to locate north of the border rather than in the north-east?

Ms Schmuecker: There is some speculation—although in the work we have done we have not been able to find evidence for it—that in the Amazon case one thing that was on their
mind was the SNP's commitment to dropping corporation tax to a Republic of Ireland level in an independent Scotland. We think that there are huge questions about their ability to do that, but that is believed to be one reason why they located where they did. Perhaps more concretely, there was also a subsidy of £1.8 million towards training costs. That leads us to a very interesting question about the degree to which there is a level playing field between the north-east of England and Scotland. Obviously, the north-east of England no longer has its regional development agency, which in the past would play a role and be involved in those kinds of negotiations, and would have had a budget to be able to make a similar sort of offer. The local enterprise partnerships that we now have in place in England do not yet have any sort of capacity and do not as yet hold budgets of the sort that would enable them to engage in that sort of activity.

**Q251 Lord Hollick:** When these decisions were made in the past, was the availability of skills at the forefront of the decision?

**Ms Schmuecker:** Absolutely. If you look at the reasons on which companies base their location decisions, tax is in there but it is not the most important thing. The most important things are the cost of labour, the adequacy of skills, transportation—a lot of things rank higher than tax in locational decisions.

**Professor Tomaney:** In the case of Gamesa, the company strongly emphasised in its public statements the package of skills and training support that the Scottish Government and Scottish Enterprise were able to provide. We cannot be 100% certain about how much that weighed in the decision, but it was certainly something that the company emphasised. I endorse what Katie Schmuecker said. In Scotland, when it comes to competition for big investments such as the Gamesa one, you have a very powerful set of institutions with a great deal of autonomy to develop their own tailor-made packages. That clearly does not exist in the English regions. It did to some extent with the regional development agencies, but we do not have those anymore; they have been replaced by local enterprise partnerships, which are on a much smaller scale. There is an inequity there, without question.

**Q252 Lord Shipley:** I have a question for Professor Simpson. The context for this is the submission that we have received from Newcastle international airport, which wants a level playing field in air passenger duty. Professor Simpson, you talked earlier on the basis of historical experience about the importance of the economy of these islands being integrated. Do you think that it is right for there to be different rates of air passenger duty within the United Kingdom—and within Ireland?

**Professor Simpson:** Your afterthought is the heart of the difficulty. Clearly, at the moment both the British Government and the Irish Government can set air passenger duty, which they do not need to harmonise. The Irish Government have taken the view that a very low level of air passenger taxation is appropriate to their needs in terms of tourism and everything else. The Northern Ireland politicians have spotted this, and we now have a very much improved infrastructure links with Dublin airport. The two main Northern Ireland airports say that they are losing a proportion—they might make it sound a bit bigger—of traffic to Dublin, where the fares can be lower because air passenger duty is lower. There is now pressure on the Northern Ireland Administration, given devolution—which is not quite independence—to set its own rate. In some ways, that is a race that I do not like to see happening. It would be better if we had better co-ordination of the arrangements.
Q253 Lord Shipley: Might it follow that such a race might occur in different kinds of taxation, not just around air passenger duty? Could what has happened in the air passenger duty field easily happen elsewhere?

Professor Simpson: Air passenger duty is the second area in which this has happened. The primary example will be seen next week, when the Treasury will be debating whether to give the Northern Ireland Administration permission to set its own level of corporation tax. That has been worked out in legal terms within the European framework following the example of the Azores—which one or two of you may have come across—under a framework whereby a region may be allowed to set its own rate of corporation tax provided that it is not subsidised from the centre. Northern Ireland hopes to get permission from a reluctant Treasury to set its own rate of corporation tax, which it would like to set at 12.5%—guess why—which would compare with the Irish rate. Indeed, a certain First Minister said that he might even make it 10%. The net result is that a proportion of Northern Ireland’s Barnett formula revenue will have to be foregone. The big issue in the debate is that the political parties are saying that they will do that, but the public are saying in opinion polls that they do not like the thought of taking away £X million from education and health in order to pay for this.

Professor Tomaney: Let me add a more general comment on this competition between airports. Clearly, across Europe there has been a huge explosion in competition between cities and regions for tourism markets based around all kinds of investment in airports. There is no question that in France, for instance, regional and city governments have in effect subsidised the development of airports in order to attract tourists. In the case of the relationship between, say, Newcastle airport and Edinburgh airport, the fear is that we too will see the quite fierce competition in the airport industry that is already happening on an Europe-wide scale, which to some extent is driven by the demands of the low-cost airlines.

Q254 Lord Levene of Portsoken: Are we not in danger of somewhat losing the plot here? If I remember correctly, air passenger duty was originally brought in to try to reduce pollution—

Lord Lawson of Blaby: That is what was said.

Lord Levene of Portsoken: I agree that is what was said. The notion that air passenger duty can be used as a competitive element to encourage more people to travel seems to cut right across the whole notion of the tax in the first place.

Professor Tomaney: That is why I made the broader point that we should not get fixated on air passenger duty, because local and regional authorities across Europe find lots of ways to support their local airports in the competition for passenger numbers. That can include building new terminals and reducing landing charges and all sorts of things. When you create new jurisdictions, there is the possibility of interjurisdictional competition. In the case of the north-east, that is something that any sensible business person or politician ought to be thinking about. These new forms of competition might emerge if we have an independent Scotland that is able to vary all kinds of taxation—not necessarily just air passenger duty—or make investments in infrastructure such as airports.

Q255 Lord Smith of Clifton: We have already touched on the Barnett formula. As you know, the Barnett formula is the means by which government expenditure is rebalanced among the nations of the UK. Given that citizens in the north have average household incomes below those in Scotland, do you believe that this balancing is unfair to the regions? In the event of Scotland becoming independent, do you expect that there would be demand
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for a similar redistributive method to the north of England? Would there also be implications for Northern Ireland? We have already touched on that to some extent.

Ms Schmuecker: In considering the Barnett formula, it is important to remember that at the moment it has no bearing whatsoever on the distribution of funding within England; it applies only to the distribution of funding to Scotland, Wales and Northern Ireland based on levels of spending in England. The Barnett formula is essentially based on spending decisions in England with a population formula and some historical practice attached to it, so it is a sort of combination of historical accident and a population formula. Certainly our research into this area has found that, if you look at the amount of spending in each part of the UK, including each English region, compared to levels of need, the amount of funding that goes to each part of the UK does not really correspond to a fair formula—if you take fairness to mean that spending is in some way in line with the level of need in the different parts of the country. Certainly, Scotland and also London emerge as the strong outliers, in that they are the places that receive more public spending overall compared to the level of need that is exhibited in socio-economic terms. Therefore, there are definitely good grounds for arguing that the Barnett formula does not deliver according to need. Of course, the Barnett formula is not designed to deliver according to need. I think that we have to remember that when we are talking about these things, and I think that a good argument can be made as to why a needs-based formula would be better.

On what might happen to the Barnett formula as we go through this process, there are two issues. One is that, under independence, the Barnett formula would no longer apply to Scotland but could carry on just as it is applying only to Wales and Northern Ireland. However, it is fair to say that the Barnett formula does not have a huge number of fans in Wales or Northern Ireland so I think that there would potentially be an opportunity for revisiting the formula at that point.

An interesting question is what happens under a devolution-max scenario because, as has been mentioned, under the Azores ruling the provision of greater fiscal autonomy to the different parts of the UK cannot be offset by fiscal transfers from the centre to make up the difference. One of the things that northern businesses tend to be a little bit concerned about is not so much Scottish independence as devolution max, which they regard as giving Scotland the best of both worlds: on the one hand devo max gives Scotland fiscal instruments to use, but on the other hand it still involves a fiscal transfer from the centre. However, I think that the Azores ruling makes it quite questionable as to how far that could be the case, because it would have to be within EU rules.

The Scotland Act has set a precedent of exchanging greater fiscal powers—more power over income tax for a reduction in the block grant.

However, when you are cutting and cutting the amount of the block grant in order to reflect the amount of fiscal autonomy that the different parts of the UK have, there comes a point at which you need to question whether the Barnett formula can be sustained. There is a big question about the point at which that might happen. Certainly, there are people in the north of England who have long regarded the Barnett formula as unfair—they regard the amount of spending per head that Scotland receives as being rather unfair—and would like to see it reformed. The difficulty of course in the case of the north of England is that, if you were to create a block grant to give to the English regions, who would spend it? There is no institution or representative body that is equivalent to the Scottish Parliament that would be able to be in receipt of that grant. There are those practical difficulties, but I certainly think that many people in the north of England would be glad to see the back of the Barnett formula.
Professor Simpson: The Barnett formula has had the effect of redistributing resources to the three territories. That is not in dispute. As Katie Schmuecker has said, the Barnett formula does not apply to the north-east or north-west, but nevertheless, in terms of identifiable expenditure in the United Kingdom, that could be argued for on the basis of need. I am just scanning the figures here: for the year 2010-11, against a United Kingdom baseline of 100, Northern Ireland’s expenditure allocation came out favourably at 121—in other words, it was 21% up—whereas Scotland came out at 115 and the north-east of England came through with 107. The important point about Scotland becoming independent is that such levels of spending would not then be in difficulty, because the hope of those arguing for Scottish independence is that they would be able to finance that level of spending because of the way in which revenue that is not currently allocated to Scotland could accrue to it.

What can be said for Wales and Northern Ireland, if they are to have devolved Administrations, is that something like a Barnett formula is necessary. Over the years—including when some here would have been in important positions in HMG—attempts have been made to assess how to introduce a needs-based formula, but we have continued to live with the Barnett formula, which is a marginal incremental adjustment formula. The Barnett formula is crude, but certainly from the Northern Ireland perspective any discussion about changing it creates the fear that the net answer would probably be lower, and that is not entirely popular.

Q256 Lord Shipley: Katie Schmuecker mentioned earlier that there is no regional body to which a block grant could be given if there was to be a disbursement along the lines of the Barnett formula. That takes me to this question: if Scotland became independent, is there more likely to be a demand in the northern regions—in the north-east in particular, where there was a referendum back in 2004 in which there was very little support, but also in Yorkshire and the north-west—for some kind of representative body that would represent more than, say, combined authorities or local enterprise partnerships? That might be north-wide or it might cover the three regions or it might be something slightly different from that.

Professor Tomaney: I think that there is often an incipient demand for more local power, but we face this paradox in the north of England that, whenever additional local power or constitutional change is offered, people reject it. That has been the case not just in the referendum on a regional assembly but in the recent mayoral referendums, which were defeated, in Newcastle and other northern cities. My view is that you could very easily envisage a situation in which tensions rise and a sense of unfairness grows among the population, but whether that would be transformed into a clearly articulated demand for a widely agreed set of institutions, I am not clear and I am not sure that I see the evidence that that would be the case. Wherever we have these constitutional proposals, it seems to be much easier to make the case against them than to make the case for them. Therefore, I do not see that as inevitable by any stretch of the imagination. That is not to say that it is impossible to create a widely founded consensus about the case for institutional reform, but I think that one of the lessons that we have learnt from previous attempts, as it were, to offset devolution to Scotland and Wales with changes in the English context—whether at the city level or at the regional level—is that this has to be something that emerges from the regions themselves rather than something that is in any way perceived as being imposed on them from the centre, however rational the arguments might be that the centre is making. That is the lesson that I draw from the failed efforts to date.

Ms Schmuecker: I would certainly agree with that, but I think what is inevitable after this process is that simply having the conversation about Scotland’s constitutional future—
whether that is devo max or independence—will have some sort of back-wash into England in the sense of a debate about how England is governed. That may well take the form of a discussion about an English Parliament or a discussion about how business is done here in the House of Commons, but I think that it is very important that, as part of that debate, there is a discussion about what decentralisation in England looks like. If England has been the hole in the middle of the devolution settlement, the way in which England is governed has been the hole in the middle of that question.

If you look at the two options that have already been rejected in referendums, the problems that they both shared was that it was not clear enough what was actually on offer and how that would be able to be used or how it would be a more powerful system than we currently have in place. It was very difficult to say in concrete terms what an elected regional assembly or an elected city mayor would be able to do above and beyond what already happens apart from some vague promise of more powers to follow, which—believe me from personal experience as one who, in a prior life, worked for the campaign for an elected regional assembly—can be difficult to sell to voters. I think that this debate will come back and we need to have a very serious discussion about what an answer to that part of the English question—the degree to which England is centralised—might look like. There are various options that are beginning to be discussed around, possibly, elected mayors for city regions or some other more powerful form of city regional government, such as a combined authority model, or even some kind of north-wide body. If you are talking about the spending of block grants, it may be that the bigger scale makes more sense there.

Professor Tomaney: Following on from what Katie Schmuecker has said, it seems to me that in England we have struggled really for about 30 or 40 years to come up with a solution to the governance of England at the sub-national scale. We have this pendulum that has swung towards regionalism in the 1960s and 1970s, back towards localism under the Thatcher and Major Governments, back towards regionalism under Labour and back now towards localism. In relation to questions of sub-national governance in England, a change of Government usually involves ripping everything up and starting again. What we seem to struggle to do is to achieve a consensus about what would be the appropriate lasting kinds of institutions at the sub-national level that would help to deal with the kinds of social and economic challenges that the north of England faces. I think that remains an outstanding challenging. It did not surprise me at all that there was a big wave of rejection of the proposals for city mayors because there was no real consensus around that idea; there was a lot of dissension in fact and a lot of opposition and controversy, mixed with an even bigger dose of ignorance and disinterest, which was really the main public response to it. I think that this is an important question, which we have consistently failed to address successfully in England.

Q257 Lord Levene of Portsoken: Professor Simpson, you were saying earlier that people in Scotland might not have realised that they had the opportunity to spend this funding that is allocated to them in different ways. Where do you think that funding would come from?

Professor Simpson: What I was trying to say was that the present Barnett formula allocation results in Scotland having a level of expenditure that, on the basis of comparison with the English regions—less so with Northern Ireland—gives a level of expenditure that must be about appropriate if not a bit generous in terms of need. The interesting thing about Scottish independence is that, if we had had to debate it in the context that Scotland would not be able to raise enough revenue to maintain its present level of services, the debate would be different. However, it has become a realistic debate because those who would see
themselves as a Scottish Government believe that they can maintain the present levels of service and possibly improve them with new arrangements. That only applies to Scotland because there is this underpinning of a very strong assumption about potential revenue.

Q258 The Chairman: Are you referring there to North Sea oil?

Professor Simpson: Yes. As Professor McCrone tried to illustrate when he gave evidence to the Committee, that makes the further assumption that Shetland—I have learnt to pronounce it as “Shetland” rather than “the Shetlands”—remains within Scotland. Obviously, we are making that assumption, but Professor McCrone drew our attention to the fact that the only other changes within the European framework within the past 40 to 50 years was when Greenland, which had been part of Denmark, decided to leave the European Community. The Faroes are also in a different relationship with Denmark. The concept of different relationships is there and is for debate. If this independence concept has to be argued through the right international institutions, the question will be: what will be the international constraints?

Q259 Lord Lipsey: Can I return to immigration policy? The current Scottish Government have indicated that, with further devolution, they would have a very liberal immigration policy, whereas the north of England, as part of Britain, would have a tightening immigration policy. Do you think that the two bits could have different policies operating? What would the effects of that be? It would be particularly interesting to have Professor Simpson’s observations on this, given the situation that has obtained in Ireland, where there has been a liberal immigration policy in the south and a more restrictive one in the north.

Professor Simpson: My assessment of the position in Northern Ireland over the past 10 to 15 years has been that we have had a liberal migration policy as part of the European Union. To my surprise, as someone who grew up never having met anyone from outside the British Isles who had come to live in Northern Ireland by choice, I find that Northern Ireland now has a very large population of Lithuanians, Latvians, some Estonians and some Poles, due to the workings of the labour market across Europe. Indeed, one of the immediate effects of the current recession has been the degree to which these immigrant communities have felt under pressure, and some have returned to from whence they came. What is happening in Northern Ireland is paralleled now in the south of Ireland, which is now living with a return to a scale of emigration that people thought had gone. That has returned because of the exceptional severity of the present changes. I would say that we have signed up to a very liberal migration policy within the European Union. You will not find many people coming to Northern Ireland from south of the Mediterranean or from the Far East, but nevertheless migrants make up a significant part of the labour force.

Professor Tomaney: This is one of a number of areas where it is difficult to predict what the outcomes would be, and I do not know of any serious research that is being done to investigate this hypothesis. One area where I have heard concern expressed is in competition for international students. Almost all British universities are now very reliant on attracting foreign students, who are a key component of their business model in most cases. If you had a situation where obtaining a student visa was very difficult for England but relatively easy for Scotland, that would be an example of where a different immigration policy regime could have quite a big economic impact on the north of England.

Beyond that, it is very difficult to predict what the effects of competition around migration laws would be. A lot would be determined by the relative state of the economies. Edinburgh and to some extent Aberdeen are successful regional economies within the Scottish context.
and have been very powerful magnets for migrants, and the Scottish Government’s fresh talent initiative was obviously aimed at all of that. By comparison, migration has not had such a big impact on the economy of north-east England because the opportunities there have not been as great: we have been growing at a slower rate and we have been creating fewer jobs than the Edinburgh and Aberdeen economies. It is a question not just of the policy regime but of the economic performance and whether there is a demand for labour, and it is very difficult to predict what the impacts of that would be.

**Ms Schmuecker:** I think that that is right. The only thing that I would add is that, when the fresh talent initiative first came about, there was a view in the north of England that the sorts of issues that Scotland was trying to tackle through that policy—attracting a high-skilled workforce that would be more entrepreneurial and more innovative and using that as a way of offsetting an ageing and declining population—are all challenges that face the northern regions as well. At the time that the fresh talent initiative was introduced, there was certainly some discussion about greater variation within immigration policy within the UK, which was something that Scotland had managed to negotiate with the UK Government despite not formally having devolved powers in that area.

**Q260 Lord Hollick:** Has the existence of free education in Scotland had a detrimental impact on the higher education institutions in the north-east? If Scotland became independent, it would be required under European rules to extend free education to those from elsewhere in the United Kingdom. That might be rather difficult to sustain.

**Professor Tomaney:** I am unaware of any detrimental impact to date on north-east universities as a result of the differences in fee regimes between Scotland and England. We do not really know what is going to happen once English fees go up to £9,000—I have asked my vice-chancellor this very question, and he said, “I don’t know”—so most universities are in a position of leaping into the dark in all of this, and it may be that there are impacts and implications that we cannot foresee. Having said that, I agree that it seems unlikely that the current Scottish policy position could be sustained in the context where an independent Scotland was a member of the EU. If the position was sustained, that would be a potentially big threat particularly to universities in the north-east, where there would be a tremendous incentive to move across the border to get low-cost higher education. That would be almost inevitable, one would have thought, but it seems unlikely to my mind that such a policy scenario would develop.

**Q261 The Chairman:** Why do you say that it would be unlikely?

**Professor Tomaney:** There are questions about how it would be paid for by the Scottish Government and there are questions of how that would be regulated at the European level. I can foresee all kinds of questions being raised about that, but it is an imponderable at this stage.

**Q262 The Chairman:** Is not the most likely scenario that the Scottish universities would have to offer no tuition fees to students coming from England?

**Professor Tomaney:** That was my point, and I wonder how a Scottish Government would fund that sort of scenario. That would require some very big decisions on the part of the Scottish Government as to how they deployed their resources in effect to subsidise the education of England’s students. How that would play out, in political terms and in media terms, I do not know, but you could envisage a situation in which a student who had to pay £9,000 a year to study at Newcastle University could go to Edinburgh University for a free education. I foresee many obstacles before we reach that point.
Q263 Baroness Kingsmill: Would it not work the other way round? Would not the Scots be obliged to abandon their free higher education policy? They would have to charge the same as the UK as part of EU law.

Professor Tomaney: That was my point.

The Chairman: That would be quite a difficult policy issue for a future Scottish Government.

Professor Simpson: I am sure that we would all agree that the current institutional arrangements are an unfortunate accident of the way in which the European rules have been framed. Would any of us have invented the present division if it had been up to us? To give an illustration of how this can become even more awkward, it is the right of anyone living in Northern Ireland to claim an Irish passport, so it is possible to arrive in Scotland carrying an Irish passport saying that you come from another country, which allows you to ask for free university education, even though you come from part of the United Kingdom and therefore should be asked to pay.

The Chairman: That is interesting.

Lord Smith of Clifton: In my experience, these things are very price sensitive. In Northern Ireland in the 1990s, the university of which I was vice-chancellor had the largest proportion of EU students of all British universities because they all came up from the south—they were Irish rather than “continental”—and that changed again when the regime changed in the Republic, which introduced fees. We then had an even bigger increase in applications from the south. There had always been a significant number of Northern Irish school leavers who went to the south, but that also stopped. And these were not big fees—we are not talking about £9,000 a year. So cross-border student transfer levels seem to be very price sensitive.

Professor Simpson: One of the artificial distortions of borders on these islands has been the way in which it has interfered with higher education.

The Chairman: But we will not go there today.

Q264 Lord McFall of Alcluith: Professor Simpson spoke about Scotland becoming independent and the Scottish Government feeling confident that they would be able to maintain the same level of services. Do you believe that such confidence is sound, in your experience?

Professor Simpson: Some of the best Scottish accents that I hear support that view, and I rely on them because of the authority with which they deliver those statements. The short answer is that the evidence as published by the Scottish Parliament gives you options that show that that is possible. I suspect that we would all prefer an authoritative analysis of that before any referendum or political decisions are ultimately made. If I were an average citizen north of the border, I would want to know whether the Scottish Government could finance itself.

Q265 Lord McFall of Alcluith: Let me say then, in the finest Scottish accent, stop giving me the patter and give your real view. Do you think that it is soundly based?

Professor Simpson: In short, my suspicion is that it is not.
Q266 Lord McFall of Alcluith: Okay, that is fine. That is what I am looking for. In terms of devo max, given that Calman has already given the Scottish Parliament power to vary taxation, what do you envisage devo max would comprise?

Ms Schmuecker: I think that it depends very much on how we get to the point of having a conversation about devo max. What I mean by that is whether it is in the referendum question. I think that, if devo max is offered as one of the referendum options, opinion polling evidence suggests that it is the most likely answer, the one which most people would support. The Scottish Government would then have a very strong basis from which to negotiate if it had a referendum answer behind it. If devo max is not included in the referendum and it comes down to a negotiation between the UK Government and the Scottish Government, I think that we are likely to see what the IPPR has started to refer to as “devo more” rather than devo max—just to introduce some more jargon into the proceedings—by which we mean something that is beyond the Scotland Act 2012 but not quite as fulsome as full fiscal autonomy or whatever people think devo max might look like.

Q267 Lord McFall of Alcluith: Perhaps Professor Tomaney could give his opinion on that and his views regarding any concerns about the possible differences in tax rates between an independent Scotland and the rest of the UK.

Professor Tomaney: This is an area where the north of England could be at an enormous disadvantage if there is an independent Scotland with a full range of tax-raising powers, including the ability to lower corporation tax below the English level and to intervene in all kinds of other ways to make Scotland tax competitive. That is a really big threat for the north of England. I also agree that, in many ways, devo max may be the bigger threat if Scotland stays within the UK but has a very substantial range of autonomy in relation to the setting of taxes, whether those are corporation tax rates, personal tax rates or whatever. That could be as big a—if not a bigger—challenge for the north of England as independence would be because it would pose quite profound challenges for the north of England, which is nowhere near having the capacity to compete in that sense.

However, I would emphasise that I see these things as part of a long, evolving process. The divergences can really be said to have begun in the 1970s when the Scottish Development Agency was first established, which gave certain kinds of economic development advantages that were not available in the north of England. In a sense, many of the debates about what is necessary for economic development in the north of England have taken their cue from developments that have taken place in Scotland. Many of the things that we are worrying about now in terms of Scotland’s ability to attract a higher proportion of foreign direct investment are already there. We can already see that Scotland has advantages. The question is how much more advantage will independence, devo max or more devolution or whatever provide.

Q268 Lord McFall of Alcluith: Under such a system, could you see a greater degree of mobility of labour across that border? As happened in the case of Northern Ireland and the Republic of Ireland, could there be huge sheds on either sides of the border determined by their favourable tax treatment on either side?

Professor Tomaney: Yes, I think that you could see that. In the case of Ireland from the end of the 1980s through the 1990s and into the 2000s—the “Celtic tiger” era—clearly, Ireland had a rapidly growing economy with huge labour shortages that was sucking in labour not just from Northern Ireland but from all over Europe. If the Scottish economy recovers through the financial services sector in Edinburgh or through the oil and gas industry around
Aberdeen continuing to grow, you can envisage a situation where people move north to take advantage of that, as they do already. A lot of the oil and gas companies in Aberdeen employ engineering workers from the north-east of England—you meet them in Amsterdam airport or Heathrow flying back from wherever they have been in the world—so that phenomenon already exists. Without question, it could accentuate.

Q269 Lord McFall of Alcluith: Professor Tomaney, I notice from your CV that you have looked at issues of identity, territory and democracy in relation to devolution in other states. In terms of the independence referendum, the economy will certainly feature. How much do you think the elements of identity, territory and democracy will feature in the referendum?

Professor Tomaney: My view is that there are plenty of examples from around the world where, if you like, questions of identity and territorial attachment trump economic arguments. There are many cases from around the world where you could make a strong argument that the countries should not have separated—Czechoslovakia may be a case in point—but, once the issue is cast in terms of identity, I think that it is very difficult to bring economic arguments to bear in those debates. The questions of identity have a power and a logic that are different to the arguments about economic development. There is always this argument that having our own institutions will allow us to develop our economy more successfully on the one hand, and on the other hand there is the argument that separating will have economic costs associated with it. In the end, my suspicion is that those arguments are not really the ones on which voters will make up their minds in referendums; they will make up their minds on much more basic questions, in which issues of identity can be—although perhaps not always—very powerful.

Q270 Lord Hollick: Three weeks ago, the Chancellor of the Exchequer suggested that he would be in favour of devolving more tax-raising powers, in particular individual taxes, to Scotland. I happened to be in Scotland at that time and it was fairly roundly rejected as being a half-measure where a full measure was needed. What was the reaction in the north-east of England?

Professor Tomaney: I am unaware that there was any reaction.

Ms Schmuecker: There was not much of a reaction.

Professor Tomaney: What you have to understand is that, with the exception of a certain number of issues that appear in the local papers, there is not a high level of understanding even among decision makers in the north-east of England about the way in which the debate in Scotland is developing. I consider myself relatively informed about these issues, but it is actually hard to find out. You have to read The Scotsman every day or listen to Radio Scotland online. You may do that when something really interesting is happening, but on a day-to-day basis even the most informed and educated people in the north-east of England do not know what is happening in Scotland and do not know what the terms of the debate are around devolution and independence. That is a bit of a worry in a sense, because there is a lot happening that our political leaders in the region should have something to say about, but they do not know and are not able to make informed comment or show leadership.

Q271 The Chairman: Does that point about lack of knowledge and lack of interest also apply to leading businessmen? I can see it applying to Joe Soap in the pub, but does it also apply to those others?
**Professor Tomaney:** To the extent that we can talk about, if you like, a north-east elite comprising political leaders and business leaders, in my experience—I talk to them individually and collectively from time to time—I do not find a high level of knowledge about what is happening in Scotland; on the contrary, I find the opposite because there is a high level of ignorance and, in many cases, misunderstanding about what is happening.

**Ms Schmuecker:** I would agree with a lot of that. Certainly some of our work on the possible implications of Scottish independence or devo max for the north of England has come about as a result of the reaction among some business leaders and political leaders about what might happen in Scotland. Regarding this fear that an independent Scotland will slash its corporation tax and business will immediately drain north over the border, our research shows that that is somewhat overplayed as there are all sorts of obstacles in the way of that happening. Similarly, on the fine-grained detail of what sorts of fiscal powers and levers might be devolved, there just is not that level of engagement with the debate at the moment. If you look back to the 1970s, politicians from the north of England scuppered devolution, but although there is interest around these questions there is not yet a very high degree of gripping the details.

**Q272 Baroness Kingsmill:** Part of the purpose of this inquiry is to raise consciousness a bit and to explore some of the issues. An interesting issue is what currency Scotland would use in the event of independence. Would it be the euro or the pound? Some have even speculated that it might be the groat or some such. There would be implications if Scotland chose to have a currency other than the pound, and it would be quite interesting to hear your views on the matter. Anecdotally, I spent my summer last year at Lake Como, where the roads were jammed with Swiss coming over the border to spend all their Swiss francs in the euro area—though a stop has been put to that now. What is your view on that issue?

**Ms Schmuecker:** That is another question that is incredibly difficult to answer with any degree of certainty whatsoever, other than to say that a lot of Scottish people whom I know complain that in England they cannot even spend the current Scottish bank notes let alone any other currency. The only thing that I can say about this, which may or may not be interesting to you, goes back to our earlier conversation about what “devo more” or devo max might look like and how an independent Scotland might be constrained in its activities. If an independent Scotland kept the pound—as the current leadership in Scotland is talking about—that would maintain a monetary relationship with the UK Government and would give the UK Government a lever with which it would be able to influence what happens in Scotland, perhaps through some sort of fiscal pact. Of course, there are other options open, such as using the euro, which may or may not be an option, or creating some other currency or simply using the pound without the UK’s permission, as some South American countries have done with the dollar. There are various options out there, and it is very difficult to say with any certainty which one Scotland might opt for. However, there is an interesting dynamic around what might happen if Scotland keeps the pound. Maintaining that element of the relationship would, I think, give the UK Government some leverage over the degree of harmonisation of tax rates, for example.

**Professor Simpson:** If I were in the unhappy position of being asked to advise an independent Scotland on what to do in terms of its currency, I would have no doubt in advising in the present circumstances, which are likely to remain for the next three to five years, to maintain parity with sterling and to make arrangements for that with the English Government—if I may use that term for the bit that would be left.
One question is whether the Scots would readily be allowed to become a member of the European Union and whether they would even apply to become a member. Let us assume for the moment that they would apply. The question would then arise as to whether the European legislation now says that new member states are expected to adopt the euro. In those circumstances, I would be saying to the Scottish Government, “Please ask the Commission not to push you down that embarrassing road at the moment, because you can maintain a friendly working relationship with sterling.”

Baroness Kingsmill: But there is no time pressure on any new member to adopt the euro.

Lord Lawson of Blaby: There is a legal requirement, but it is without a deadline.

Professor Simpson: Okay, you can sign a promissory note.

An important precedent that may be useful is what happened to the Irish. The Irish maintained parity with sterling all the way through from 1920 until the moment that the ERM became part of the philosophy with the prospect of the euro, but we did not get upset about that. Irish notes were circulated—they were called punts—and they were at parity and there was no doubt about the matter. There was no debate that I am aware of about using the Irish central bank as a lender of last resort, yet there was an Irish central bank—not to be confused with the Bank of Ireland, which is a commercial bank—but life went on and it was a surprise to all of us when the Irish currency then diverged from sterling after what must have been over 50 years.

Lord Tugendhat: We live in a different world now from that of the 1920s, 1930s and 1940s.

Professor Simpson: That is true, but the thought that we need to make a break, with no currency link, is an unnecessary constraint. We could negotiate a currency arrangement whereby sterling would be maintained so long as the Scottish monetary authority—whatever it might be called—behaved in a way that was consistent with maintaining the value of sterling.

Q273 Baroness Kingsmill: It seems a slightly hypothetical thought to suggest that Scotland would do anything other than maintain parity with sterling, but much of what we are talking about is hypothetical because we are trying to get to the essence of these things. Do you think that there would be any adverse consequences for the north of England or for other parts of the UK if there were two currencies?

Professor Tomaney: This is extraordinarily difficult to predict. All that I can say is that I am not aware of any serious study that has looked into this. On that basis, I will maintain silence.

Baroness Kingsmill: We are grateful to academics who appear before us because they have time to think about these things, whereas others do not.

Professor Tomaney: To be perfectly and totally honest, I have not given any thought to this question and that is why I am maintaining a dignified silence.

Professor Simpson: If you are talking about two currencies with parity of value—in other words, the pound and the Scottish note would be worth one for one—the island of Ireland demonstrated that in the 1950s and thereafter. There was no difficulty. The tension comes when, for whatever reason, you want to alter the relative value and allow devaluation, which changes the monetary arrangements. But I think that we can envisage a Scottish situation over the next decade where, with sensible arrangements, there would be no need to think of a separate currency unit.
**Professor Tomaney:** Baroness Kingsmill has probably set out a very good master’s student dissertation project, which I will take back with me.

**Baroness Kingsmill:** We would very grateful to hear the fruits of it, such as they may be.

**The Chairman:** We are getting an analysis of the currency issues from some of our other witnesses, so it might be worth your looking at what they have to say to us.

**Q274 Lord Levene of Portsoken:** In the event of Scottish independence, do you think that in itself might have an effect on the rate of growth of the Scottish economy?

**Professor Tomaney:** Again, that is a very difficult thing to predict in advance. I take the view that, if Scotland becomes independent, the break will not be as sharp as we might think in terms of its economic performance. Scotland has been moving in the direction of relatively good economic performance for quite some time, so I do not see independence making that much difference to that trend. Scotland has two very well performing sub-regional economies in the Edinburgh region and the Aberdeen region, and I do not see Scottish independence necessarily making much difference to the performance of those two regions.

As to what evidence we can draw from elsewhere in the world, we can draw on the Irish example of independence, which led to a retrograde economic performance throughout most of the 20th century. We can point to other examples in central and eastern Europe—up until about 2008 anyway—where countries that left the USSR then performed remarkably well. However, the context is everything here. It is not simply the constitutional arrangements but the wider economic context; it not just what is happening in Scotland but what is happening in neighbouring countries, including not just the UK but elsewhere in Europe. It is very difficult to say that independence will contribute to a better or worse economic performance.

**Q275 Lord Levene of Portsoken:** What about the other side of the coin? Would Scottish independence have any effect on the growth rate and the economy of Northern Ireland or the north of England?

**Professor Tomaney:** It could make a difference if there were a growth of interjurisdictional competition. That could make a big difference. If Scotland were able to compete more effectively, for instance for foreign direct investment or for labour, that could be very detrimental. However, I would say that the longer-term threat to the north of England—if you want to put it in those terms—is less from what happens in Scotland than from what happens in London and the south-east of England. The really big divergence in economic performance is not between the north-east and Scotland—although there has been a divergence—but between the north of England and London and the greater south-east, which is pulling away in economic terms from the rest of the country. One danger of this debate in the north of England—and as we come closer to independence, the danger rises all the time—is that we think that this is the big issue when really the big issue is our relationship with London and the south, where the really big gaps in economic performance lie.

**Q276 Lord Levene of Portsoken:** But we are looking specifically in this context at what effect this would have either on the Scottish side of the equation or on the rest of England side of the equation.

**Professor Tomaney:** One effect could be that we give far too much attention to the Scottish question and not enough attention to our relationship with London and the south, which is crucial. How resources are distributed around England, how we construct industrial
policy and the degree to which that has a regional component, and what happens to the future of local government are all really big questions.

**Professor Simpson:** To pick up on what Lord Levene said about the difference between the north and south-east of England, it occurs to me that what we have lived through in the past three to four years is an effective devaluation of costs in the north of England relative to the south, which may need to go a lot further before it makes a big difference to economic activity. The change in the cost structure of everything is likely ultimately to do something to twist the balance of what is happening in England. To go back to the original question, if the independence of Scotland and the setting up of its own Government is not clear-cut and is done with any sense of apprehension that the economic integration of these islands will in any way be disrupted, in the lead-in and first few years of Scottish independence, the thought of uncertainty will damage prospects for Scottish development. At the moment people are not saying with certainty that Scotland will become independent and that they know exactly how it will function from day one.

**Q277 Lord Levene of Portsoken:** That is exactly why we are having this inquiry—to try to find out what the implications might be, so that when people come to make a decision they will do it with their eyes rather more widely open than they were before they had seen what we had been able to find out.

**Professor Simpson:** But the net result, depending on how your Committee deliberates, will be that if you can set a series of statements about what the assumptions are on which Scottish independence ought to take place—if you are going to make a judgment—or might take place if you are softening it, there will be issues about relationships with the European Community, the relationship of Scotland to the European Community, the currency situation and the limits on fair competition in terms of the economy as opposed to a level playing field across the business community on these islands. If you can paint a picture which then becomes attractive and can sell it, a Scottish Government might have a better prospect. That was not how you set out, was it?

**The Chairman:** I think we are looking more neutrally to see what the implications are. A lot of the things that you said today demonstrate that a lot of people have not really thought about the implications, from the currency to the volatility of North Sea oil, for example, and a whole number of other issues. This is what we are seeking to probe and make some conclusions on before the vote.

**Q278 Lord Lawson of Blaby:** I would like to get away from independence and talk about devo max, because it is also within our terms of reference to look at the consequences of this. I think it was Professor Tomaney who suggested that in so far as there was a threat to the north of England, and in particular to the north-east of England, it might come more from devo max than from independence. Devo max might be a way for the Scots to have their cake and eat it. Of course, whereas with independence the Barnett formula hand-outs would disappear, with devo max presumably they would not. Certainly the formula has endured for a long time beyond all reason—except for political reason. What thought is being given in the north of England to what should be the response to devo max in Scotland? Would the north of England argue against devo max—or, as Katie said, “devo more” or “devo a little bit more”? Would the north of England say, “If they are going to have devo max, we want a whole lot of new powers”? Where does the situation go?

**Professor Tomaney:** My view on this is that there is no considered north of England opinion on these issues. There was some leadership on these questions until about 2010.
Organisations such as the Northern Way, and to some extent the regional development agencies, had the capacity to do some thinking on these questions. The Northern Way, on behalf of the regional development agencies in the north of England, contributed to the Calman commission. That was the beginning of some thinking that could have been very useful, but it has since gone. No doubt Katie Schmuecker will talk about what IPPR’s commission is doing. My view is that there is no widespread consensus across the north of England about what we should do next. There are lots of different ideas, but they do not go very deeply into the political structures that are now made up mainly of local authorities and so on. There are no large regional-level institutions that can represent the north of England in that sense. Devo max throws up some very profound questions for the north of England, but there is not a huge amount of sophisticated thinking about how the north of England should respond. Even where that sophisticated thinking is taking place, it does not extend very widely.

Ms Schmuecker: Certainly, as John Tomaney alluded to in his answer, IPPR North—as you are doing in this inquiry—is trying to bring greater clarity to these issues and to raise some of the questions more broadly in the north. The idea that devo max is the best of both worlds we have to treat with a bit of caution because of EU rulings that we have seen in other parts of Europe—particularly the Azores ruling in Portugal. It is quite clear in European precedent that if a country or region is given fiscal autonomy, this cannot be offset by a central transfer if the way in which it chooses to use that autonomy has negative implications for its budget, because it then falls foul of EU state aid rules. The precedent has been set, so if we do have some form of devo max that involves substantial fiscal autonomy for Scotland, it will have to be offset by cuts to the Barnett formula grant. Certainly one of the concerns of those in the north of England who are beginning to think about these issues is that Scotland will be able to slash its corporation tax on the one hand and still receive its Barnett formula on the other. I find it extremely difficult to believe that that would be the outcome of any negotiation, let alone be legal in European terms.

The big problem for the north of England is the lack of a level playing field that I talked about earlier. As we saw with the Amazon decision, Scotland already has the capacity to offer subsidies to foreign direct investment, which is beyond what the north of England can do. It can already create its own regional industrial policy, which the north of England cannot do. It also has resources to put behind such a strategy. It already has economic powers that the north of England does not, and they are probably set to grow. This is not an argument against devolving more powers, but for ensuring that other parts of England have the capacity to compete. There are some proximity issues and some reasons why the north of England will feel this—perhaps the north-east of England in particular, because the population is a bit further to the north. Capital is more mobile than labour, but you may get some movement of labour across the border if there is a favourable income tax regime in Scotland, for example. Scotland is already capable of attracting mobile capital in a way that perhaps the north of England cannot—and we know that capital is more mobile than labour, so if Scotland is able to give an even better offer, we may see a continuation of that trend, to the detriment of the economy of the north of England.

But we have to be very careful and be very clear about the constraints that Scotland will face in its room for manoeuvre. It is not Ireland in the 1990s. It will not be able to slash corporation tax in the same way. It has a much bigger welfare state that it may have to pay for under a maximal version of devo max. There are constraints on borrowing and on the degree to which it will be willing to slash spending further. All those things will constrain its ability to slash corporation tax, which is the one area about which businesses in the north of England, in so far as they have thought about this, are concerned.
Professor Tomaney: Perhaps I may add something to that. I agree that to the extent that this issue is discussed among businesses, the discussion tends to focus on the idea that corporation tax will be crucial to Scotland’s competitiveness in the future. I do not think that actors in the north of England understand that Scotland’s relatively superior economic performance over the past 20 or 30 years has been based not on tax competition but on the emergence of two world-class economic clusters in the form of financial services in Edinburgh and oil and gas in Aberdeen. They have not arisen as a result of tax competition. They have arisen to a large extent as a result of adept industrial policy interventions on the part of Scottish institutions. If you look at the competition that is taking place between the north of England and Scotland in relation to the offshore wind energy industry, the degree of sophistication that you see in Scotland in terms of plans for the development of the sector is far superior to what you will find in England. That is not to say that the north of England will not get some investment—and it has had some investment in this sector—but Scotland’s attractions are not just to do with the financial incentives that it can offer now and might be able to offer in future. They are to do with much more subtle forms of support in areas such as skills, technology and so on. It is these long-term policies that have made a difference in Scotland.

The Chairman: Thank you very much indeed for coming. Several of my colleagues have referred to the fact that there is not a great debate even in the south of England about a lot of the issues such as the currency, the volatility of North Sea oil and the impacts of all of these and many other issues. That is precisely the reason that we established this inquiry—to try to illuminate some of these issues before any crucial votes are taken. I was fascinated by some of your responses that indicated that there is not much interest in the north-east at the present time in this. The point that Ms Schmuecker referred to about proximity was one of the reasons why we particularly wanted to have this session with you this afternoon. Obviously that is very obvious in the case of the north-east of England. I hope that you will follow our further sessions and ultimately our final report, which will come out later this year. Meanwhile, I thank you very much for coming.
Professor Charlie Jeffery and David Hume Institute—Oral evidence (QQ 526-547)

Transcript to be found under David Hume Institute and Professor Charlie Jeffery—Oral evidence (QQ 526-547)
MEMBERS PRESENT

Lord MacGregor of Pulham Market (Chairman)
Lord Currie of Marylebone
Lord Forsyth of Drumlean
Lord Hollick
Lord Lawson of Blaby
Baroness Kingsmill
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witness

Professor John Kay, Oxford University

Q56 The Chairman: Professor Kay, welcome to the Economic Affairs Committee. This is the second public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. I stressed last week, and I would like to stress again, that this is not about the politics of independence. We take a dispassionate view about that. Nor is it about constitutional issues. As is right for our committee, we are focusing purely on the economic implications, and of course, the economic implications affecting England, Wales and Northern Ireland as well as Scotland. Copies are available in the room of Members’ entries in the register of interests as far as this inquiry is concerned.

Professor Kay, like me I see that you were born and educated in Scotland but spent most of your time down south. We are looking forward very much to hearing your perspective on these issues, as a wide-ranging economist, commentator and academic. Could I also say that we had Professor David Bell, in somewhat the same category last week? I do not know whether you have had a chance to look at that.
Professor John Kay—Oral evidence (QQ 56-116)

Professor Kay: I have not had an opportunity to see what David Bell said to you.

The Chairman: That is fine. We will wait to see what you say to us.

Professor Kay: And how often I contradict him or not, as the case may be.

Q57 The Chairman: That will be our fun afterwards. As I said, thank you very much for coming. Needless to say, I know you are familiar with this, but could I remind you to speak loud and clear for the webcast and the shorthand writer?

I want to kick off with a fairly general question. If Scotland became independent from the rest of the UK, it would become necessary to divide some of the current UK’s stock of assets and liabilities. We went over a number of these with Professor Bell last week. Which do you think are the most important from an economic perspective, for Scotland and the rest of the UK? What would you use as your guiding principles in making a division?

Professor Kay: I suppose that the starting guiding principle is that, if it is a physical asset, you begin by looking at the physical location. If it is a financial asset or liability, you start from some kind of pro rata share, so that a whole variety of buildings and related infrastructure assets are naturally the property of the Scottish Government as, in a real sense, they are already in most cases. Whereas, on the liability side, let us say with debt, your starting point is that you agree some pro rating of items like that, probably on a population basis, so that something like 8.5% of the UK debt is Scottish would be a natural starting point.

Having said these things, you then get into a whole variety of complications. I don’t know whether they are the most important issues, but certainly there are a large group of difficult issues. There is a group that comes somewhere between the two, being partly financial assets, partly physical assets. The easier ones are some businesses that the Government own. Royal Mail, or Network Rail. Technically the Government do not own Network Rail, but that is the reality. There is a relatively easy division into the Scottish mail and English mail, and Scottish and English railway.

Financial institutions are more difficult. The Bank of England is a curious complication. It is a particular complication at the moment because we have talked about pro rating UK Government debt, and of course much the largest owner of UK Government debt is the Bank of England at present. That leads into issues on currency and monetary arrangements, which I think we will come to later. There are other financial institutions which are quasi-nationalised: basically, RBS and Lloyds. One probably starts by treating them as financial assets, especially since there are outside shareholders in both of them, which would say that the major stake in these institutions remained with the English Government, but that is clearly something to be discussed, debated and negotiated, as so many things have to be discussed, debated and negotiated.

Then you get to a group of other institutions that have a sort of intermediate status. The BBC would be an example of that. You could have a continuing British Broadcasting Corporation, and that would plainly make a lot of sense. You could try to split a Scottish broadcasting corporation from an English broadcasting corporation. There are a variety of institutions about which you have these issues.

The one remaining big category of asset liability is probably pensions. There you have to deal with state pensions, public sector pensions, both unfunded, particularly Civil Service pension funds. Some of the funded pensions schemes—the teachers’ schemes, say, are relatively easy—because they are separate at the moment, but the legacy schemes of the former nationalised industries, the coal pension fund, as it were, would be a good example. All of these are
actually quite complicated. Having said that these issues are quite complicated and quite technical, they are very important to the people involved.

**Q58 The Chairman:** Have you any thought as to how the public sector pension liabilities might be treated? Divided?

**Professor Kay:** Public sector state pensions have, as you know, complications that arise from EU rules which, quite sensibly from an EU perspective, say that you cannot discriminate against people by virtue of their place of residence. This basically says that if you have worked in a country for a period of time you are entitled to a pension from that country, and are entitled whether you live in England, Scotland, Latvia or France. You may know that that produces complications in relation to the Czech Republic and Slovakia, which are, I think, in dispute at the moment, because the Czechs, who have a materially higher standard of living, want to treat pensioners who live there more generously regardless of whether the people involved worked in the Czech Republic or Slovakia when it was Czechoslovakia. You can see that we have analogous issues in Scotland. I do not think there are easy answers to this question, because I do not know to what extent we are able to reconstruct relevant records for 40-50 years, which we would need to be able to do to implement that kind of principle properly. But there is a compelling logic to the principle that if you have a pension in a certain place, you are entitled to go on receiving the pension from that place.

**The Chairman:** Although many people have moved across the border for jobs and their pension record over a long period.

**Professor Kay:** Yes

**Q59 The Chairman:** What about defence assets?

**Professor Kay:** That kind of depends on what the defence policy of an independent Scotland turns out to be. It would make quite a lot of sense simply to have an agreement on defence between the two countries, in which case a sharing of the costs and facilities of defence would be part of that. But that appears not to be what a lot of people who talk about an independent Scotland have in mind. They have in mind an independent defence and foreign policy. If you do that, you have to negotiate almost line by line the splitting up of the existing military capabilities and facilities. But I am not an expert on defence.

**Q60 Lord Tugendhat:** I want to look at the other side of the balance: namely, the UK’s current joint public expenditure flows, including social security, health and Barnett formula transfers—defence has been mentioned. In particular, I wonder which services you think should continue to be jointly provided by an independent Scotland and the rest of the UK, and to what extent you think Scotland would be better off with a geographic claim to the oil revenue but without Barnett formula transfers.

**Professor Kay:** There is a general question that one probably needs to raise about the position from which I am answering these questions. I have some views on what should happen but I am trying to approach this topic in the spirit of this committee by saying what the issues and problems are and how they could be resolved, rather than saying, “This is what an independent Scotland would be like and this is what we are driving towards”. Perhaps it is almost the kind of position that might arise on some issues were one an arbiter saying what was an reasonable position for the potentially independent states to agree on.

**Lord Lawson of Blaby:** If I may say so, I think the Committee would be interested in both.
Q61 Lord Tugendhat: We raise the questions and you define whether you think these questions should be asked. After all, the purpose of having you is to know what you think might be reasonable answers, and other people will give their answers.

The Chairman: We want your analysis as well as your views.

Professor Kay: As you know, the Barnett formula came into being in the late 1970s. It is structured in a way in which there ought to have been convergence between public expenditure per head in Scotland and public expenditure in the rest of the UK. That convergence has not really occurred in practice, for complex and obscure reasons. I have taken the view that the best way of defining the status quo has been to say that in return for a relatively generous public expenditure settlement, the issue of what the right division of the oil revenues should be is allowed, if not to go away, at any rate to rest on the back burner. There are technical, legal issues of supposing one applied international jurisdictional rules to what part of the oil revenues would accrue to Scotland, but most of the analysis I have seen seems to suggest that the larger parts of it would accrue to Scotland. If one does a sum on that basis and takes it over the last 20 or 30 years, the additional expenditure in Scotland does not look very different in total from the kind of additional revenue allocation one would make by doing it on that basis. So it all fits together with that being the sort of deal. It is rather a good deal for Scotland at least in a sense that oil revenues are by their nature rather unstable, whereas the flow of expenditure to Scotland that has come from it is relatively secure. While there is a lot of discussion in Scotland about whether Scotland would be better off in public expenditure terms or not, it is probably not a big issue either way. Even a £500 payment one way or another that one opinion poll suggested would swing independent opinion in Scotland either for or against independence is probably a larger amount than is at issue on this particular front. I think that the important issue is not so much whether Scotland would benefit more from oil revenues or English cross-subsidy but whether the Scottish economy would perform better or worse if there were a greater degree of autonomy.

Q62 Lord Forsyth of Drumlean: In your previous answer, you suggested that the debt should be apportioned according to population at 8.5%. Is that because you think that the revenues from North Sea oil compensate for that? The expenditure has been much higher than the relative share of population, and with it the accumulated debt. Why do you think that the debt should not be related to the amount that is being spent? Do you see the oil argument as compensating for that?

Professor Kay: No, not really. The reason why I would start with a pro rata share is to say that an agreement around independence cannot be an unwinding of history. You cannot ask the hypothetical question: what would have been the position if these countries had been separate for—I do not know how long—10, 20 or hundreds of years?

Q63 Lord Forsyth of Drumlean: But historically Scotland has always enjoyed a higher expenditure per head than the rest of the United Kingdom. As the debt has been accumulated on that, it seems out of kilter and very generous to suggest that it should be done on the basis of population.

Professor Kay: You would have to ask why—if you wanted to pose that question, although I have given you the reason why I do not think you should even frame it. What if one asserts that public opinion in Scotland was more hostile to the Iraq war than public opinion in the UK as a whole, which I suspect is probably true, and that therefore a higher proportion of
the costs should be allocated to the English taxpayer than the Scottish taxpayer? Once you start opening these arguments, you can conduct them forever—for hundreds of years.

Q64 Lord Lipsey: I can see going back that you can say that Barnett for oil was a fair swap, but as we go forward, the oil is bound at some point to go into decline. Meanwhile the additional spending commitments that the Scottish Government have undertaken—free care, free prescriptions, free tuition—will not go away. Indeed, some of them are increasing particularly fast. Is there not going to be a serious fiscal imbalance in Scotland over time?

Professor Kay: I think that there is going to be some but the date on which the oil goes away; it keeps receding into the future and I suspect that it will continue to do so. The additional spending in Scotland that you describe for personal care, university tuition, and so on, has more to do with the effects of the UK spending splurge in the period 2000 to 2006 than to the Barnett formula as such, although both of those things came together. It is quite important as background to all this discussion to say that in the first six or seven years of devolution, the Scottish Government and the Scottish Parliament just had too much money to spend. That was not conducive to forming very responsible habits and approaches to public expenditure in Scotland.

Q65 Lord Lawson of Blaby: This is, as you say, all very complicated, but one thing is quite simple and that is the Barnett formula. If there is independence, then clearly there is no precedent or case for transfers, and the Barnett formula would presumably continue to apply in respect of England, Wales and Northern Ireland. However, the formula would be a contradiction in terms between two independent sovereign states.

Professor Kay: That is plainly right. There could be no continuing transfer of this kind and Scotland would have to finance its activities from its own revenues. There could be no question of a block grant from the UK of the kind that currently exists.

Q66 Baroness Kingsmill: What sort of scale would that be? Would that be a saving for the UK Government?

Professor Kay: Well, that is the converse of the question, would it be a benefit to—

Baroness Kingsmill: Yes, I know, but what sort of scale are we talking about? This inquiry is looking at the impact of Scottish devolution on the rest of the UK rather than the impact upon Scotland, so I would like to get a feel for weighing up the scales here. Is this going to be significant?

Professor Kay: The amounts we are talking about are of the order of £5 billion to £10 billion in addition on the expenditure side and similar sums on the revenue side—these are obviously gross amounts. The effect on the UK, and conversely upon Scotland, is the net amount, so in the totality of the rest of the UK public expenditure. I hope I can talk about England in substitution for the rest of the UK, not to offend people in Wales and Northern Ireland but because otherwise it gets very convoluted.

Baroness Kingsmill: We can allow you that.

Professor Kay: If you could, I would be grateful. The effect of the rest of the UK net is not going to be very large.

Baroness Kingsmill: We are going to have to get a balance sheet together, weighing up what it is going to cost and what we are going to lose. When I say “we”, I am referring to Northern Ireland, England and Wales. That is the balance sheet that we are going to have to work out, so your assistance with that has been great.
Q67  Lord Smith of Clifton: Professor Kay, let us go on to currencies. In the event of an independent Scotland, which currency do you expect it will use, what do you consider should be the key economic issues behind this decision, and is there a case for Scotland joining the euro or whatever succeeds it, or even issuing its own currency?

Professor Kay: There are three basic options: one is the euro; one is the pound; and the other is an independent Scottish currency, which I like to call the groat or the bawbee—

Lord Smith of Clifton: Absolutely, the groat.

Professor Kay: You would prefer the groat? Right, we shall go for the groat.

I think the case for the euro is weak and not just because of the current turmoil in the eurozone. This is mainly because Scotland’s principal trading partner is England and Scotland is heavily integrated into the economy of what is currently the United Kingdom. In truth, if one looks in retrospect, membership of the euro has not worked terribly well for Ireland over the past decade for essentially these reasons.

There is at least one technical issue with the euro and you will be hearing from other people on this because it veers into constitutional issues. If Scotland applied for membership of the EU, as one presumes it would, then it has to commit to the fact that the euro is the currency of the EU. However, an independent Scotland would not be likely to meet the Maastricht criteria on the kind of envelope numbers one would have from an independent Scotland, so that would not arise as an immediate issue. I also suspect there is a lot less inclination on the part of people in Europe to bend the rules in favour of letting additional countries into Europe now.

I think we should probably rule out the euro. That leaves the groat.

Q68  Lord Forsyth of Drumlean: Are you saying that you do not think they would be allowed membership of the European Union?

Professor Kay: No, I think they would be allowed membership of the European Union and that membership of the euro would not be a condition of such membership.

Q69  Lord Lawson of Blaby: I suspect that under the treaty it is necessary for membership of the euro to be a condition, but it is not immediate membership. I think the legal position is—although we will need to take evidence on this—that they will be required to get into a condition where they do qualify. I think it is absolutely clear that under the present law—they could, of course, change it—membership of European monetary union is a condition of the European Union.

Baroness Kingsmill: But there is no time limit on it.

Lord Lawson of Blaby: There is no fixed date because they would be told they have got to get their economy into shape.

Professor Kay: Also there are likely to be other developments within the eurozone rather more quickly than that.

Lord Lawson of Blaby: It might not exist.

Professor Kay: There are a number of issues arising here that we shall probably want to consider when we talk about Scottish membership of the European Union and its implications because there are more general issues there.
To get back to the currency issue, that leaves us the groat or the pound. The obvious advantage of the groat is that, if you mean independence, one of the things you mean is an independent currency. This is one of the obvious marks of independence. One of the questions here, which I think we might come back to several times, is what exactly is this discussion about independence about, certainly as far as the economic issues are concerned?

It is perhaps better to start with the other possibility, which is Scotland continuing to have the pound. That could be done and would most plausibly be achieved as part of an agreement on monetary union with England. That raises a batch of questions about what the terms of monetary union would be, what the provisions of such an agreement would contain and what mechanisms there would be for making it happen.

There is an idea that has been floating around, which is what I call the Montenegrain solution. Montenegro is a European country that has adopted the euro as its currency. It has no currency of its own, but it is not a member of the eurozone. It is not even a member of the EU. It simply declared the euro to be its currency unilaterally. That means that the euros used in Montenegro effectively have to be imported from the European Union by trade between Montenegro and the EU. The policies of the Montenegrain Government in both the fiscal and monetary sphere are constrained by the need to maintain the stability of the balances which that particular requirement necessitates. It might be interesting for your inquiry to explore Montenegro further, although perhaps it is not large enough to provide a model for what could happen here.

It is an illustration, however—even if it seems rather improbable—that Scotland could simply adopt the pound unilaterally. It is not an impossible option and it is not very different from what happened in Ireland immediately after independence in the 1920s, when Ireland effectively continued to be part of the UK monetary union although it did not have any influence over the Bank of England and was not participating in that sense in the UK economy. As I say, Montenegro is small and not the most sophisticated financial country in the world. Ireland was also operating in a world with a very much less sophisticated and complex financial system than we now have.

Between the options we have described, there are a range of others. If one is pushed towards looking at the groat seriously, it is mainly because in the present circumstances it might be quite difficult to negotiate what would plainly be the best arrangement, which would see the Bank of England continuing to be the monetary authority for both Scotland and England, with a substantive monetary union between the two independent states.

Q70 Lord Rowe-Beddoe: Was that the Irish model, going back to the 1920s?

Professor Kay: No, it was not. The Irish model was much closer to the unilateral adoption of sterling as the currency of Ireland. Then there were Irish notes, the creation of an Irish central bank and a gradual evolution. Even until 1979, the Irish currency and the English currency exchanged interchangeably within Ireland, but that changed when Ireland joined European monetary union.

Q71 Lord Tugendhat: Can I just clarify? I remember very clearly that there were Irish coins. Were there Irish notes, as distinct from notes issued by the Ulster Bank and the Bank of Ireland, rather as the Royal Bank of Scotland and Clydesdale issue? I am not sure that there were Irish Free State notes, if you follow me.

Professor Kay: I think there were.

Lord Rowe-Beddoe: There was a central bank, called the Irish Central Bank—
Lord Tugendhat: I remember going to Ireland as a child—

Lord Rowe-Beddoe: It was a punt—it was not in Northern Ireland.

Lord Tugendhat: It was Southern Ireland.

Lord Rowe-Beddoe: Southern Ireland Central Bank issued its own punts, from 1920 to 1979.

Professor Kay: I do not think that it was as early as 1920.

Lord Tugendhat: Regular British notes and 10 shilling notes circulated as well.

Professor Kay: Yes, and the reality was, as I understand it, that in Ireland British pound notes and Irish punts circulated interchangeably. But it was hard to get a cab driver in London to accept an Irish punt, just as it is slightly hard—but not very hard—to get him to accept a Scottish pound now.

Q72 Lord Rowe-Beddoe: Is it not Liberia which has the US dollar as its currency?

Professor Kay: Yes, there are various countries—I am sure you know better than I do. Are you saying that there is no Liberian currency?

Lord Rowe-Beddoe: There is no Liberian note and there is no Panamanian note.

Q73 Lord Forsyth of Drumlean: To get back to your point—were you to have the Bank of England performing this dual role with the groat—

Professor Kay: No, I am assuming that if there was a groat, there would be a Scottish central bank which would issue groats, and Scottish banks would hold groat deposits at the Scottish central bank.

Q74 Lord Forsyth of Drumlean: So you would have a completely separate monetary authority?

Professor Kay: Yes. It might be pegged to the pound sterling, of course.

Q75 Lord Forsyth of Drumlean: On the example where they just keep the pound, and they do not have the groat, what would be the disadvantage from the point of view of people living in Scotland? Clearly there would be no democratic accountability, although these days it is difficult to see what democratic accountability applies to the central bank in practice, anyway. What would be the disadvantage, if any?

Professor Kay: Scotland would clearly not be free to determine its own monetary policy, which in principle, if it adopted the groat, it would be. Obviously, if the groat were pegged either formally or informally to the pound, that monetary freedom would be limited. But at any rate, it would potentially exist.

Q76 Lord Forsyth of Drumlean: In terms of ordinary people's lives, what would the difference be? One obvious thing would be that the mortgage rate could not be influenced by the Government, if the Government so chose to do. What would be the disadvantage and how would it relate to the fluctuation in the oil price, which is, of course, a dollar oil price, and on which quite a large part of the income of Scotland will depend? That is what I cannot get my head round.

Professor Kay: In the case that we are talking about, there would be very little difference in this area in the experience of the people of Scotland from what they experience now.
There would be an independent Scotland, but for these economic purposes an independent Scotland would not have powers that the Scottish Government currently lacks. The question arises, obviously, of what fiscal powers and authority the Scottish Government would have.

**Q77  The Chairman:** Is that in the case where they continue to have sterling?

**Professor Kay:** This is the case where they continue to have sterling.

**Q78  The Chairman:** If it is the groat, presumably—in terms of lender of last resort, control over monetary policy and so on—it would be the independent Scottish central bank?

**Professor Kay:** I think that we should separate out the issue of lender of last resort and ask what that means. I am assuming that there is a monetary union. There are several hypothetical options. The simplest and clearest is a monetary union between Scotland and England, analogous in many respects to the existing monetary union within the eurozone, in that there is a single monetary authority for Scotland and England, which presumably would be the Bank of England. It is rather hard to imagine why an English Government should agree to anything else. In that case, one imagines that the Bank of England would behave pretty much as it does now, and might as part of an agreement be in a Scottish representative on the Monetary Policy Committee or some change of that kind. But as far as monetary arrangements and monetary policy are concerned, there would not be much difference between the situation then and the status quo.

**Q79  The Chairman:** And the Scottish representative would not have a veto?

**Professor Kay:** Scotland could no doubt ask for a veto, but it is hard to see why the English Government should concede that.

**Q80  Lord Lawson of Blaby:** If you were to be in the Scottish Government, which option would you choose? I ask this because it is the Scottish Government who would have to decide this. Which would you choose, and why?

**Professor Kay:** As the Scottish Government, I would attempt to negotiate this arrangement and I would have to ask whether the terms of the fiscal monetary pact I could negotiate were acceptable and consistent with what I wanted to achieve by creating an independent Scotland. That would be a tough negotiation.

**Q81  Lord McFall of Alcluith:** Would you accept much fiscal latitude?

**Professor Kay:** On behalf of the Scottish Government, I would argue for some fiscal latitude.

**Lord McFall of Alcluith:** It would not be great.

**Professor Kay:** If I was arguing on behalf of the Scottish Government, I would ask for quite a lot of fiscal latitude. For example, the fiscal convergence implied, say, by the new European stability pact is actually a lot more than is necessary to have a monetary union. But that gets us into the issues of how events have worked out in the eurozone. If a fiscal autonomy in Scotland is to mean anything, one has to establish the principles: first, that the Scottish Government could borrow; secondly, that the Scottish Government would be responsible for their own debts; and, thirdly, that the English Government would have no liability whatever and that it would be clear to people on the international markets that it had no
liability for the debts of the Scottish Government. Then one could negotiate a significantly looser fiscal arrangement.

**Q82  Lord Forsyth of Drumlean:** Is that realistic? It would be a bit like having the Royal Bank of Scotland. Would a Scotland on our borders not be too big to fail? In practice, you might have that agreement, but if the oil price halved, say, and they had gone off on some spending spree and got into great difficulties, and they were using the pound, in practice would we not be in a position where we could not see a neighbour using our currency fail?

**Professor Kay:** No, I do not think that that is right. If one goes back to the eurozone case—that the eurozone problem would have been much less critical than it has become, and if one accepted back in 2009, or, better still, it was made clear at a much earlier stage of evolution of the European monetary system that there was no central guarantee of the debts of individual countries—it is unlikely that spreads of interest rates within the eurozone would ever have become as narrow as they did.

**The Chairman:** Can we do Lord Currie and then Lord Shipley and Lord Lawson?

**Q83  Lord Currie of Marylebone:** I am trying to understand how lender of last resort functions would operate in this monetary union. The Bank of England has responsibility for monetary policy. Would it have a limit of last resort role with respect to institutions in Scotland? Given that the lender of last resort role tends to have a tax liability behind it, where does that leave the fiscal arrangements between the two countries?

**Professor Kay:** I think that one has to unpick what lender of last resort means. When you and I did courses in money and banking, not terribly recently—actually, these courses do not exist anymore—“lender of last resort” was a concept told about the following story. It was possible for a solvent bank to get into liquidity difficulties because there was a run on it from depositors. In that case the central bank could halt the run by agreeing to take good security from the bank in return for loans at a penal interest rate, with the expectation that the run would be stopped and that the bank in question would be able to repay that. If there were in Scotland a simple, boring bank of that traditional kind which got into difficulties of that traditional kind, you do not even need a central bank to deal with that. A Scottish Government guarantee of deposits would be enough to stop the run. Indeed, now that we have deposit protection, that particular aspect of the lender of last resort role is not important. The term “lender of last resort” now seems to be generalised to encompass supportive operations for very complex banks whose main activities are trading and wholesale money markets and which suffer from combined crises of both solvency and liquidity, which are not capable of being disentangled.

For example, if Northern Rock had been a Scottish institution and the Northern Rock problem had emerged essentially in isolation, a government or a local monetary institution could have dealt with a problem of that kind perfectly well. Dealing with the Royal Bank of Scotland is another matter altogether.

**Q84  Lord Shipley:** You said earlier that this could all be subject to negotiation but we are discussing fundamental issues. Do you think that they should be clarified before a referendum takes place so that people understand what they are, or can they be safely left to post-referendum negotiation?

**Professor Kay:** I do not see how they could possibly be worked through in detail before a referendum. I have a lot of sympathy with those who have said that if all this is to happen, it must be a two-stage process. One stage is that you decide on the principle that you want to
create an independent state and then, having described the detail of an independent state, you ask people again, “Having seen exactly what an independent state is like, is it something that you want?”.

Q85 Lord Lawson of Blaby: So you are suggesting that there would be a referendum and, if the decision was for independence, there would possibly be years—or months at least—of acrimonious haggling; and that, at the end of the day, if there were an agreement, that would also need to be put in a referendum. Is that what you are saying?

Professor Kay: I am straying slightly outside my brief by moving on to the constitutional side, but I am certainly saying that there would have to be years of negotiation if the principle of independence were approved in a referendum.

Q86 Lord Lawson of Blaby: Going back to the question that you answered a little while back, you said something that may, I suggest, have been mistaken. You said that had it been clear at an early stage in the creation of European monetary union—the eurozone—that countries were on their own, there might have been a greater spread of interest rates. There was; that was part of the treaty. Part of the treaty was the so-called no bailout clause, under which no country that got into difficulties would be bailed out by either any other country or by the European Union as a whole through the central bank. This had no credibility whatever. It was there in law but it had no credibility. The banks did not believe it; they were prepared to lend to Greeks as though they were Germans. The countries concerned did not believe it. They thought that they would be bailed out if they got into difficulties, which is what has happened. The financial markets did not believe it, either. Therefore, you will have to do something quite different if you are to prevent this replicating itself. It is not enough to have it as the legal basis. It was and is the legal basis for the eurozone but it is just a scrap of paper.

Professor Kay: I very much recognise what you are saying. I remember saying to students in the late 1990s that monetary union means that, essentially, differential inflation risk is replaced by differential credit risk. Therefore, when you move into a monetary union, the currency risk associated with international lending is reduced but the credit risk associated with it is increased. From a very short time after the formation of the union, that appeared not to be true. As you described, spreads narrowed very rapidly and by 2007 had become almost imperceptible.

My interpretation of that is that it suited a great many people to make that particular confusion. It suited a range of European institutions, whose intention was to create a much more binding fiscal and monetary union from this process than was contained in the treaty. It suited people in the financial markets for whom the idea that the Germans and other north European countries underpinned the whole of European debt is a very convenient fiction. It also suited quite a lot of European politicians, who enjoyed the multinational behaviour and grandstanding that is offered by intervening in a crisis in other EU member states.

If there is a difference in Scotland, it is that there is a different starting point. It starts with Scotland wanting to assert fiscal autonomy, rather than with having a great many parties which are concerned to try to elide that autonomy. If that is understood from the beginning, it can develop in a different way.

Q87 Lord Lawson of Blaby: May I just press this point? They might behave like that, but there is a huge risk and moral hazard of the Scottish Government behaving irresponsibly because they are bound to be bailed out if they get into difficulties, in much the same way
that many banks behaved in a grossly irresponsible way because they thought that they would be bailed out by the taxpayer. How do you prevent this moral hazard?

Professor Kay: I think by rather clear statements that you will not. After all, most Californian debt is not underwritten by the US federal Government. More than that, markets do not believe that it is underwritten by the US federal Government and nor does California. The spreads on that Californian debt have recently been 300 basis points. They are much larger than were observed in the eurozone. To my mind, the US illustrates that it is possible to have a currency union without, in the relevant sense, having this agreement on fiscal policies across the United States. That has an important practical consequence, which is that the majority of states either have budget balance requirements or practise budget balances. However, not all of them, as California illustrates, implement these practices. When they do not implement them they run into trouble, not as a result of treaty obligations or diktats imposed on them by the US federal Government, but as a result of the realities imposed on them by the market and the difficulty that they have in borrowing. I do not see why one should not adopt for Scotland a model that owes more to the American experience than to the eurozone experience. I think that there would be quite strong reasons and desires for trying to do so.

Q88 Lord Forsyth of Drumlean: I am sorry to come back to my previous question, when you said that it would make no difference to the ordinary person in Scotland. However, if there was no moral hazard and it was absolutely clear that the debts would not be underwritten, would that not imply that there would be a less generous credit rating for Scotland and, therefore, that people would pay higher interest rates?

Professor Kay: There would be a less generous credit rating for Scotland. I do not think it would necessarily have a much worse credit rating initially. That does not necessarily mean that Scots, as distinct from the Scottish Government, would pay higher interest rates. It would not necessarily mean that you paid more on your mortgage. To go back to the Californian case, it is rather obvious that a lot of individual Californians are better credit risks than the state of California.

Q89 The Chairman: Could I just go back to a reply you gave earlier in relation to a lender of last resort and the illustration of Northern Rock? You said that RBS would be a different matter. How would you see a situation such as RBS being resolved in those circumstances?

Professor Kay: If Scotland had been independent in 2008, the Scottish Government would have had three core options. One would have been to say, as the Irish Government did, “Don’t worry, we will guarantee everything”. In that case, Scotland would essentially be bust. The situation in Scotland would have been much worse than the one in Ireland. It would quite quickly have become not credible that the Scottish Government could do that.

The second option would have been to put together a package to which Scotland would contribute, but would be run principally by the English and US Governments, to bail out RBS. There is a good chance that you could have achieved that, but you would have had a very short time to negotiate it and it would have been a tough negotiation. The experience so far of trying to do such things by international agreement, as in Fortis, has not worked out terribly well.

The third option would essentially have been for the Scottish Government to seize the Scottish assets of RBS and say, “We’re going to put the whole thing into administration”. In which case, the English and American Governments would no doubt have done the same for
the retail operations of RBS in those countries. A large part of the wholesale investment banking activities would have gone into administration. In some ways, that might have been the best outcome, even from the UK’s point of view.

**Q90 Lord Tugendhat:** Can I come back to your exchanges with Lord Lawson and Lord Forsyth, arising out of the EMU situation? Surely one should look at the relationship between the United Kingdom and Ireland, or England and an independent Scotland from a slightly different perspective: just as the United States basically stood behind Mexico when it went down the tube, because Mexico was so close, there was the risk of contamination, there were trade links and all the rest. We all know, without it having been clearly defined, that Britain’s position vis-à-vis Ireland, notwithstanding Ireland being a member of economic and monetary union, is quite different from Britain’s position vis-à-vis Greece, to take an example. We have assisted Ireland and one can imagine circumstances in which we would assist it again, but we would not be willing to assist some other EU members.

Likewise, if Scotland were independent and got into horrendous problems, we would stand behind it, because the failure of Scotland would create too much difficulty for the rest of us. I was talking to Lord Forsyth after the last meeting we had and he drew a parallel with what happened in 1707 after the Darien failure—

**Professor Kay:** It was a parallel that was going through my mind as you were describing it.

**Lord Tugendhat:** The Darien failure meant Scotland needed—

**Professor Kay:** The price of the bailout, it should be said, was union with England.

**Lord Tugendhat:** It seems to me that if Scotland got into deep trouble, the fact is the English would be obliged to assist. Whether we would then revert to 1707 is another matter.

**Professor Kay:** I am sure that it is right that England, as a good neighbour, would help if Scotland went bust, just as the US has assisted with a wide variety of failures in Latin America. That is not the same as saying that these countries will be bailed out, and it is certainly not the same as telling creditors that we stand behind your debts. In the latest crisis, the UK has helped Ireland, as you would expect it would and should, but that is far from saying that we will take over the debts of Anglo-Irish Bank, which is not a good idea for anyone to do.

**The Chairman:** This has been a very important and useful discussion, but we must move on.

**Q91 Lord Currie of Marylebone:** We have touched on a number of the functions of the Bank of England in the course of our discussion, but we have not talked directly about one specific area which will become their function: regulation. How do you see financial regulation being managed, either in the great scenario or in the monetary union scenario? Would Scotland have its own financial regulators or would that force it back to England?

**Professor Kay:** I have anticipated that it would; and part of the reason is that some of the current narrative about independence in Scotland runs that regulation of financial institutions in the UK was very badly done. If it had been better done, as it is suggested it would have been in an independent Scotland, the failures of RBS and HBOS would not have occurred. One may think there are some weaknesses in that particular story, but it is sufficiently widely believed that it is hard to imagine an independent Scotland saying, “We will just pack regulation back to the English Government”.

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Q92 Lord Currie of Marylebone: Is there any concern among financial institutions in Scotland about those scenarios?

Professor Kay: There is not much. The bank story is plainly complicated and the future of bank regulation in either country—or indeed in Europe—is complicated. As far as other areas of financial services are concerned, the expectation is that, even if there were an independent Scottish financial conduct authority, it would not be very different in rulebook or behaviour from the English one. I suspect, although I rather regret, that this is probably right.

Q93 Lord Hollick: One of the hallmarks of an independent country is the ability to set its own tax rates. What scope do you think an independent Scotland would have to set its own tax rates, both personal and corporate? What impact could that have on the remains of the United Kingdom? We have an example with Ireland. Ireland has been very aggressive in reducing certain taxes. As a result, it has attracted quite a few companies and enterprises to set up there as opposed to, formerly, setting up in London. Is the same situation going to apply?

Professor Kay: I think that this has been noticed both in Scotland and outside Scotland. In my view, the result has been much discussion in Scotland about having an Irish-type corporation tax rate. That is an attractive option for Scotland. However, my view is that there is no chance that an independent Scotland would be allowed to have it. Either it would be part of the negotiations, which in most scenarios would be arrived at with England in order to reach an independence settlement in relation to the other issues we have been discussing. Equally, in relation to Scotland’s membership of the European Union, while technically setting corporation tax rates is something the treaty currently reserves to member states, given that Scotland has discussed the idea of setting a 12.5% corporation tax rate, not doing so would be one of the headline items on the negotiation agenda for people in Brussels, with whom the Scottish accession was discussed.

That is an observation on the corporation tax front. On the front of other taxes, the reality of the Scottish situation would be pretty much similar to the Irish situation in relation to the big taxes: income tax, social security taxes and value added tax. Scotland could set different rates to the other countries of the current United Kingdom. They could not be that different, given a degree of both labour and shopping mobility, without setting up large distortions. If you look at the Irish position, what you typically find is that the structure is rather similar but not identical, the rates are similar but a bit higher in Ireland. I suspect one would end up with a similar situation in Scotland.

Q94 Lord Lipsey: I wanted to discuss what interest Scotland would pay on the share it got of the national debt. It seems to me to be a question related to the oil price. You can imagine that with a high oil price, Scotland might look like it has a great debt to buy because there is very little risk of sovereign default. If the oil price went low, you could be landed with serious fiscal problems and therefore, it might be expected to pay a big premium on its debt. Do you think the likelihood is that on average it would be paying more, less or about the same as England?

Professor Kay: There would be these issues, but I imagine that Scotland would want to act in a way that would stabilise these fluctuations. Plainly it could, both in adjusting its spending and, in the case of an independent or pegged Scottish currency, acting to accumulate monetary balances when oil prices were high and reducing them when they were low. Norway has not suffered that kind of instability, for example, nor would the other developed
countries which could manage these resources relatively well, although Australia has some of the problems you have described. However, the resource proportion in Australia is not bigger than the oil impact would be in Scotland. I think it could be managed.

The issue of Scottish debt is more a question of Scotland being a new borrower, a small country, an unknown borrower and it is not obvious from recent experience of the kind of statements that are made about what a Scottish Government would do, that one could be confident that an independent Scottish Government in their early years would behave very prudently. I think it would be sensible to have doubts about Scottish capabilities initially, and that would be reflected in market prices. To get back to our earlier discussion, that is especially true if the English Government make it clear that they do not stand behind Scotland’s debt.

Lord Lipsey: Politics and economics at that point become somewhat inseparable. If the politics is mishandled, people start having doubts about the economics.

Professor Kay: Yes.

Q95 Lord McFall of Alcluith: I remember reading an article of yours in Scotland on Sunday or the Sunday Herald which said that in the case of RBS HBOS, Scotland could not have handled that. Is that—

Professor Kay: Scotland could not have handled it in the way that the UK Government did. Yes.

Lord McFall of Alcluith: In the FT, you had an article on 31 January, which was headlined “The pound is a poison pill for an independent Scotland”.

Professor Kay: I want to explain that I write most of the words in these articles but I definitely do not write the headlines. So I will accept responsibility for what appeared under the headline—I will not accept responsibility for that.

Lord McFall of Alcluith: So it is not and will not be a poison pill?

Professor Kay: I do not think that that is a phrase I would subscribe to.

Lord McFall of Alcluith: You should get back to the FT on that. On the point of economics: do you think that the debate in Scotland will be judged on the heart rather than the head; on the emotional rather than the empirical, so that in a way we are wasting our time here?

Professor Kay: I think that it will actually be judged on a mixture of each. You may have seen another piece I wrote on the £500 question, in which I said that I think you would not have swayed the vote in Ireland or in India by telling the population that they would be £500 worse off if they voted for independence. It is an indication of the— in a sense— fundamentally more trivial nature of this argument in Scotland, which is not to say that the issues round about Scottish identity and the affirmation of that are not real issues—I think that they are.

Q96 Lord Rowe-Beddoe: I am going to ask you about the comparison of economic structures, but before I do: a little earlier on you said that you thought negotiation would take years. Could you comment on that? We have a referendum; the outcome, let us assume, is “Yes”, but its implementation takes years.

Professor Kay: Yes. If you just start spelling out the issues that we have talked about in the last hour, you start to realise how much detail there actually has to be to make all this work.
There is a whole variety of things, such as setting up tax administrations, welfare systems and the like, which requires a very lengthy period of preparation.

**Q97 Baroness Kingsmill:** Can I ask a sort of follow-through on that? Do you think there would be a leakage for the north of England, for example? Do you think that once this principle had been established that Scotland could be independent—it is actually only a question of a somewhat artificial border—do you think the north of England might feel that it ought to be declaring independence?

**Professor Kay:** I rather doubt that. When you say that it is an artificial border, it is not that artificial a border. There is a large area which is pretty thinly populated between the south of Scotland and the north of England.

**Baroness Kingsmill:** But do you anticipate there being any sort of leakage?

**Professor Kay:** The big worry is the period which we just described in answer to the previous question. There is a lengthy period in which there would be quite a lot of uncertainty about what the outcome of this process is actually going to look like, and I think that a lot of people will get very nervous during that process.

**Q98 Lord Tugendhat:** Can I just follow you up on that? When one looks at the Canadian experience in the long run-up to the referendum in Quebec, there is a lot of evidence that businesses moved out of Montreal, and that Quebec lost out, on a fairly permanent basis in many respects, to neighbouring provinces. In the light of what you have just said—and I must say that I completely agree that it would take a very long time for the implications of Scottish independence to settle down—I would expect, although I do not know whether you would agree, that that would have a very damaging effect on business investment in Scotland, and that companies, not knowing what the situation is going to be, would tend to hold fire, and maybe shift resources, if not to this country then to elsewhere in the European Union.

**Professor Kay:** I think that it is slightly different from the Quebec situation. In the case of Quebec, it is rather more that business knew what an independent Quebec would be like, and did not like it. It trivialises it to say that it is because Quebec is French-speaking, but it is actually not just quite an important element in the picture but something that is indicative of what would have been a genuinely different country in a way that I cannot easily imagine you would ever feel Scotland was. I am much more concerned about this period of uncertainty, in which there are a lot of specifics on which people making business decisions need to take into account.

**Lord Tugendhat:** That is exactly what I meant, that people would need the specifics—

**Professor Kay:** That people would be deterred from taking actions.

**Baroness Kingsmill:** But there could be leakage through to the UK.

**Professor Kay:** I think that there would be leakage through to the UK, but, as it were, Wales and Northern Ireland would benefit from that.

**Q99 Baroness Kingsmill:** When I said that there was an artificial boundary I meant, of course, that as far as a business was concerned, the choices as to where to establish a business would be a lot less to do with simple geography of that rather artificial boundary in that way. Business would be making that decision on the basis of stability, on the basis of tax rates and on the basis of a whole lot of economic factors. A long period of uncertainty
would, it seems likely to me, mean a potential leakage away of economic activity from Scotland to the UK and elsewhere.

**Professor Kay:** I think that that is right. I may have misinterpreted your question. I was thinking really of the difference between, say, Scotland and Wales, in this respect, where the Welsh-English border is extremely permeable and a high proportion of the population of Wales actually lives rather close to the English border.

**Q100 Lord Rowe-Beddoe:** Could you address this question of comparing the economic structure of Scotland as it currently is, to that of the rest of the United Kingdom? How do you envisage that it would change if Scotland were to become independent?

**Professor Kay:** If one takes the oil issue, which we have discussed, out of it, I am struck by how similar the economic structure of Scotland looks to that of the UK as a whole. I have said a few times that the similarities are much more striking than the differences. So I think Scotland is pretty well integrated into the UK economy; it does not have an economic structure that differs other than in quite modest respects from the UK economy as a whole, and therefore I do not expect there to be very large change.

The largest issue in some ways—perhaps the largest issue in the whole debate, is whether we think that an independent Scotland would to some degree help release entrepreneurial energy in Scotland, or whether the policies of a Scottish Government would depress them. I can see arguments on both sides of that debate, but that, I think, is probably the biggest issue, if one asks, “Would this kind of move be beneficial or detrimental to Scotland or the Scottish economy?”

**Q101 Lord Forsyth of Drumlean:** When you say that it is not very dissimilar, I am rather surprised at that answer, because surely one of the characteristics of Scotland is that is has a very much higher proportion of people employed by and directly and indirectly dependent on public expenditure—on the public sector. There is, relatively speaking, a greater imbalance than if one looked at the rest of the United Kingdom as a whole.

**Professor Kay:** It is not actually much higher. If you look at the figures, I think that the proportion who are employed in public sector activities is about 2% higher in Scotland than in the UK. It is higher, but the idea that one hears a bit, that Scotland is like, as it were, Northern Ireland, with a very large proportion of its population dependent on the state, is not true.

**Lord Forsyth of Drumlean:** What are the numbers that you are relying on?

**Professor Kay:** I am relying on employment survey numbers.

**Lord Forsyth of Drumlean:** We can check the numbers, but I am under the impression that more than half the working population in Scotland is either directly or indirectly dependent on public expenditure.

**Professor Kay:** The Chairman: Lord Kingsmill—Baroness Kingsmill.

**Baroness Kingsmill:** I know, I fit in so well.
The Chairman: I was going to skip you for a reason you know very well. I thought you might disappear and I was going on to Lord Shipley.

Baroness Kingsmill: I would not want to miss my turn.

The Chairman: Can I just ask you?

Q102 Baroness Kingsmill: If Scotland were to become independent, do you expect to see an emerging imbalance of trading goods and services with the rest of the UK? Do you see that any difference in the flows to the rest of the UK could be offset by flows to other countries?

Professor Kay: I do not think that there would be much change. I do not see a reason to expect much change especially if, as we were discussing, the effect of exchange rates between Scotland and England remained much the same. I cannot see why it would be likely to change very much.

Q103 Baroness Kingsmill: If, for example, Scotland took control of the oil reserves and started exporting to other countries, how would that be?

Professor Kay: The oil is going into the world markets at the moment and would continue to do so. What you would expect would happen to the oil would be just the same.

Baroness Kingsmill: It would not affect the bilateral trade at all as far as you are concerned?

Professor Kay: All it would affect would be the flow of tax revenues from it.

Q104 Baroness Kingsmill: But could you not envisage that Scotland might for example get a new lease of life from independence and start to exploit its resources in a more vigorous and entrepreneurial way?

Professor Kay: There have been a lot of claims made for independence but that it makes the oil flow better is not one of them.

Baroness Kingsmill: I meant to find better markets and to use their resources in a more entrepreneurial way.

Professor Kay: The oil resources? These things are being done by large international companies who are the only people who have the capabilities to do that. I do not see a change there. I can think of a number of industries in Scotland that could be more entrepreneurially developed in world markets than they are at the moment. Scotland has a food industry that is an underdeveloped asset. Its tourist potential is not as fully realised as it ought to be. Scotland has this odd position: I cannot think of another case where you use name of the country for the name of the product, in terms of Scotch whisky, and it actually derives very little benefit from whisky production.

Q105 Baroness Kingsmill: But do you think there is a sufficient possibility that this would affect trade flows?

Professor Kay: No, unless as we have described there is a real explosion of entrepreneurial activity as a result of this. I think one would be optimistic to expect that to happen quickly as a result of independence.

Q106 Lord Shipley: Could I pursue the question of oil revenues because there is an expectation that the revenues from oil, if 90% went to Scotland, would be used to make up
for the loss of the Barnett formula, as I understood you to say earlier. However, that begs
the question that the oil is Scottish. Could you just tell us who you think owns the oil?

Professor Kay: I am not the person you should ask that question to. This is one for
international lawyers, not for me. I am simply reporting on the economic implications of
things people have told me about this issue.

Q107 Lord Shipley: Do you have a view about the Crown Estate’s role?

Professor Kay: I find the role of the Crown Estate extremely odd.

Lord Shipley: Could you explain a bit more what you think about that?

Professor Kay: As you know, it means that the Crown derives revenues from certain
offshore activities which can range from wind power, landing submarine cables, and oil
reserves which are brought onshore in the land of the United Kingdom. It seems to me that
that is a historic anomaly: it would be perfectly plain that in a rational world these resources
belong to the Government of the country concerned, which I think becomes the de facto
position. I would assume a sensible outcome is that, if there are separate Governments,
these revenues, and anything else that might be derived from them, accrue to the
Government of the state where whatever it might be is landed.

The Chairman: There might well have to be negotiation about the Crown Estates, actually.

Professor Kay: I can see that.

The Chairman: When you consider the geographical distribution of its activities.

Professor Kay: And whose coast it is.

Q108 Lord Shipley: We talked a moment ago about innovation and entrepreneurship
and I am interested to get your view as to what the nature of the economy would be like if
Scotland was independent and then there would be the rest of what is currently the United
Kingdom. In terms of the private sector, is it likely to produce competition between the two
countries or is it likely to increase complementarity? Would each side of the border play to
its individual strengths and the sum might end up being greater than the parts, or do you
think that it might be a bit more destructive than that because, say, tax policies may not be
harmonised between the two parts and it may actually increase competition?

Professor Kay: There are some areas where competition is destructive and corporation tax
is one example. I think there would be more competition than complementarity. I am
generally quite keen on competition. I am inclined to regard that as a good thing rather than
a bad thing.

This discussion is moving towards a couple of issues that I regard as really quite important to
this debate which are relevant to the competition, innovation and entrepreneurship agenda.
One is that there has been a drain of corporate headquarters out of Scotland steadily over
decades. That has been damaging to the Scottish economy, both in a direct sense and an
indirect sense that it has increased the incentive for people who want to develop managerial
careers in business to do so outside Scotland. It may be too late to reverse that
phenomenon but it has worked to Scotland’s disadvantage. The other is this question that
Scotland has had a certain amount of internally generated entrepreneurial activity over the
last 20 or 30 years. It is slightly odd in the sense that it has come not through the traditional
Scottish educational system that people in Scotland congratulate themselves on. The people
who have led it have been typically self-made people who left school at an early stage—bus
drivers and apprentices and so on have been behind the revival of companies. Scotland has
developed, rather oddly, as the leader in bus companies around the world. The large question about independence is whether one can encourage more such entrepreneurship and whether one can have more—it is a rather unfortunate phrase but one tends to want to use it—middle-class entrepreneurship than we have had, which we have had mainly in financial services, not always with good results.

Q109 Lord Tugendhat: I agree with your point about the drain of corporate headquarters but this is not a particularly Scottish phenomenon. There has been a drain of corporate headquarters from the north of England and the midlands and so forth. It is a broader UK problem, which in turn is because of the dominant position of London. One sees a somewhat analogous situation in terms of Canada and the United States, with the pull of New York and Chicago. I do not think that it would require anything as drastic as independence or indeed a change of devolution for that to be reversed. One has seen recently the development of First Group and Stagecoach which are not insignificant companies. I think that it is perfectly possible, and one has seen how the financial services industry in Edinburgh has retained headquarters. I think that this is a matter of corporate decision-making and the attractiveness of the environment, which might or might not be improved by independence but which is not necessarily linked to independence.

Professor Kay: There are issues there that are not directly causally linked to the constitutional status that may be related to it. It is very hard to avoid, if you go to Edinburgh now, the sense that there has been some increase in self-confidence and energy resulting from devolution to Scotland, which is unconnected with the constitutional mechanics of devolution and certainly not stimulated by the quality of debate within the Scottish Parliament.

Q110 Lord Tugendhat: But I would have thought there has also been an increase in self-confidence in the environment in Glasgow which arises from the renovation and rejuvenation of the place.

Professor Kay: I think that that is true and the demise of the worst kind of traditional, municipal socialism.

Q111 Lord Forsyth of Drumlean: You will forgive me, Lord Chairman, if I point out that, just on the point about the headquarters, which I very much agree with, and all that follows from that, one of the biggest factors that resulted in the moving of headquarters out of Scotland southwards was the programme of nationalisation. If you look at the companies, you say that it is rather odd that we should have become leaders in bus companies, but it is also true that we are leaders in energy companies and that happened because of a privatisation programme, which was somewhat difficult to achieve—it was countercultural.

Professor Kay: Although it is interesting, following through on that, that is really a matter of centralisation rather than nationalisation. That was possible because, while there was a Central Electricity Generating Board in England, there were two separate integrated Scottish power companies, which in turn became SSE and Scottish Power after privatisation.

Lord Forsyth of Drumlean: Indeed, and those then went on to take over English companies, like Manweb and others. Really, if you look now at the companies that are left which are forces in Scotland, they are either financial services or they are privatised former state companies.

I want to ask you a slightly cheeky question, which you may not want to answer. If you were to move back to your native Edinburgh, having looked at all these arguments very carefully,
and had to vote in the referendum, which do you think would actually result in most benefit to Scotland and the rest of the UK—the status quo or independence?

Professor Kay: I think that I should refuse to answer that question, if you will excuse me.

Q112 Lord Forsyth of Drumlean: That is a shame. I think I know what the answer is. Do you expect Scottish independence to make any difference to the underlying growth rate of the Scottish economy?

Professor Kay: The key issues from that point of view are the ones that we have been discussing, of whether independence operates in a way that stimulates entrepreneurship in Scotland.

Lord Forsyth of Drumlean: I am asking what you expect and what your own conclusion would be.

Professor Kay: I am ducking this question in a sense, but I think that there would be both effects, actually. It is very difficult, without knowing much more than one even could know about the nature of the constitutional settlement and the nature of a Scottish Government after it, to answer that. One of the big uncertainties is what, if independence happened, the structure of Scottish politics after independence would look like.

Q113 Lord Forsyth of Drumlean: Perhaps I can ask the question from another angle. Let us say that we have the referendum, we have the negotiations and Scotland becomes an independent country. What do you think the effect on England would be of that separation and on the view that the rest of the world might have of the rest of the UK minus Scotland and the fact that this fracture had happened?

Professor Kay: I think that, as far as England is concerned, this is just an enormous nuisance. As we have said this afternoon, there are a whole variety of issues that would absorb a great deal of the time of politicians in England and of civil servants in Whitehall that are clearly totally peripheral to the main issues and problems that confront us.

Lord Forsyth of Drumlean: So you do not see that the rest of the world as inward investors and so on would regard the disintegration of Britain as anything other than a modest change in the circumstances of England.

Professor Kay: I think that it would be regarded as rather odd but not as a great catastrophe that had befallen the United Kingdom.

Q114 Lord Lawson of Blaby: Can I come back to questions relating to the options for Scotland if there is a vote for independence? Obviously, the first problem which you have identified—and I agree with you—is this prolonged period of haggling and uncertainty as a result, which is obviously unhelpful. What would be the objective, if you were to be advising the Prime Minister of a newly independent Scotland? Would you advise him first of all to go for membership of the European Union, given that it is a condition of EU membership that you sign up to the euro as a currency, and given also that there is no doubt that if you wanted this tax flexibility, you would not have it? As you know, the European Union has tried very hard to persuade the Irish to drop their anomalously low corporation tax and the Irish have had to be extremely tough in resisting this pressure. If it were a question of a new country applying for membership, it would be a condition, clearly, that it did not have an Irish-type corporation tax. You would lose a lot of freedom—whether that freedom is valuable is another matter—if you became members of the European Union, so what would you advise a rational newly independent Scotland to do?
**Professor Kay:** To be frank, I had not thought seriously about the EEA option ahead of this discussion.

**Lord Lawson of Blaby:** To be like Norway?

**Professor Kay:** Yes. Given that the EU is not trying very hard at the moment to make it a very attractive club to join, the EEA option seems to have more attractions than one might easily have thought. Assuming that it is an option that would be available, which I guess it probably would be, it is certainly an option that would be worth considering.

**Lord Lawson of Blaby:** It might well be an attractive offer, although it would require the agreement of the European Union.

**Professor Kay:** It would, and there is obviously the issue that has been behind all these discussions, that Scotland is clearly an extremely plausible member of the European Union. On the other hand there are other countries which, while they could hardly realistically veto Scottish membership, have reasons, because of concerns about their own separatist movements, not to make this process particularly easy, or particularly comfortable, and that does cause me some concern.

Q115 **Lord Lawson of Blaby:** I think that that is very well put, if I may say so. Let me ask one last question. Given that Scotland has got quite a large financial sector—admittedly, the two Scottish banks are now taxpayer owned because they went belly-up, but in insurance and pension funds and so on there is a big financial sector—do you think that there is a danger of it being like Iceland in having an excessive and dangerous dependence on the financial sector, which has its own volatility?

**Professor Kay:** No. I do not think that it is like Iceland at all. First, the financial sector is much smaller, relative to the Scottish economy, than the financial sector was, at least in terms of aggregate statistics, in relation to Iceland. Secondly, the Scottish financial sector is much more firmly based in real useful value-adding services—asset management, insurance and the like—than the Icelandic financial sector. I think that there are some truths in the analogy in relation to the 2007-08 blow-up of the banks, but in terms of the Scottish financial sector as it is today I do not think that the comparison is well made.

**The Chairman:** We must stop very shortly, so Lord Hollick will ask the last question.

Q116 **Lord Hollick:** The most helpful analysis this afternoon has been in the context of independence or the status quo. A lot of commentators believe that the direction of travel would be somewhere between those two. You have pointed up in your responses a number of opportunities for Scotland and also a desire for Scotland to have a much greater say over its own affairs. Would you like to tell us whether you feel that much greater devolution could deliver the sorts of benefits that you have identified and whether that could be done within the context of a United Kingdom, without going into these extremely difficult issues of separation?

**Professor Kay:** I think that it could be done within the context of the United Kingdom, but whether, in fact, it would be, given the characteristic attitudes on the part of Whitehall and the Treasury that currently exist, I do not know. One issue that I find difficult is that there is an argument that it would require something like the shock of an independence vote in a referendum to enable really major changes to be made in the relationship between Scotland and the rest of the United Kingdom.

**The Chairman:** We are going to have to stop very soon.
Professor Kay: I think most of the greater freedom in fiscal policy and such slight freedom in monetary policies as would be available to an independent Scotland could be achieved within the framework of the United Kingdom.

The Chairman: Professor Kay, we must stop there, but I think that the stimulus you have provided for us this afternoon is shown by the length of our hearing this afternoon. You have provided us with fresh insights and some further very interesting avenues to pursue, so we are very grateful to you. Thank you very much for coming and for being so patient in answering all the questions.

Professor Kay: Thank you.
Professor Alex Kemp—Written evidence

Memorandum submitted by Professor Alex Kemp, University of Aberdeen

THE IMPLICATIONS OF SCOTTISH INDEPENDENCE FOR THE NORTH SEA OIL AND GAS SECTOR

1. There are several implications of Scottish independence for the oil and gas sector in the UK Continental Shelf. First, the boundary between Scotland and the rest of the UK needs to be established as a priority to inform investors. Secondly, early clarification on the status of the licences already awarded in what would become the Scottish sector is required. Thirdly, clarification of the operation of the special taxation system applicable to the upstream oil and gas industry in what would become the Scottish sector is needed. Fourthly, clarification is required on the health and safety régime applicable to the Scottish sector. These subjects are discussed below in turn.

2. The boundary between Scotland and the rest of the UKCS would initially be subject to determination by negotiation between the two governments with the possibility of referral to the International Court in the absence of an agreement. There is a presumption that the median line extending from the boundary between Scotland and England just north of Berwick into the North Sea would form the basis of negotiations. The median line has been employed in the past in negotiations between the UK government and other governments with continental shelves extending into the North Sea. Importantly, the median line has also been employed for purposes of the demarcation of Fisheries Management responsibilities in the North Sea between the Scottish and UK governments since 1999. This line is shown in Figure 1 below. It has been employed in the modelling of the possible division of revenues discussed below. It should be noted that departures from the median line principle have occurred in various settlements around the world, including judgements made by the International Court.
3. Currently the oil companies hold long term licences awarded by DECC on behalf of the UK government for exploitation of hydrocarbons from the UKCS. The status of these following Scottish independence requires clarification. The most obvious reaction of a Scottish government would be to honour these licences which apply to the Scottish sector. It should be recalled that a licence can relate to several blocks and in these circumstances it is possible that some blocks are in the Scottish sector and some in the rest of the UK sector. In this situation replacement licences for the
blocks might have to be issued by the two governments. This should not be a difficult operation. Currently the Scottish government does not possess an organisation to issue licences and monitor/regulate activities in the UKCS and one would need to be established. The vast amount of information relating to the fields and acreage within the Scottish sector would need to be transferred to the new Scottish authority. Such information includes well and seismic data, field development plans, and decommissioning plans. Apart from issuing licences, approving development plans, and monitoring the implementation of licence conditions a Scottish authority (Department of Energy?) would have responsibilities for several other important initiatives and activities currently undertaken by DECC. These include the fallow block and field initiative, the stewardship initiative, and the government responsibilities relating to third party access to infrastructure. There are also growing responsibilities relating to decommissioning and the environment. Altogether these are weighty commitments. (It should be noted that some of the above work is currently undertaken in the DECC office located in Aberdeen).

4. There is a special taxation system applicable to the UKCS. There are three elements, namely Corporation Tax (CT) at 30% rate, Supplementary Charge (SC) at 32% rate, and Petroleum Revenue Tax (PRT) at 50%. The whole system is very complex. Thus SC now contains a series of field allowances relating to small fields, HP/HT fields, heavy oil fields, remote gas fields, large deep-water fields, large, shallow-water fields, and high cost brownfield projects. PRT is levied on a field basis, also with complex allowances. For this tax there should be no major problem in establishing the costs, revenues, and tax allowances attributable to the fields in the Scottish and rest of UK sectors. When decommissioning time comes field losses are clawed back against PRT paid in earlier years. Hence information going back many years is required to calculate the tax refund. A potential complication is that the period of loss clawback could extend back from a period of Scottish independence to a date before independence.

5. CT and SC are levied on the basis of a ring fence covering all of the UKCS (and onshore upstream activities). This means that allowances relating to eligible expenditures in one field can be set against income in other fields for tax purposes. This can mean that an allowance emanating from expenditure in what would become the rest of the UK sector can currently be set off against income arising from within the Scottish sector. After independence there would be a need to separate the activities pertaining to the Scottish and non-Scottish sectors for purposes of calculating taxable income and tax payments for CT and SC.

6. To undertake this work effectively much knowledge and data would be required of the accumulated tax allowances and other information required to calculate taxable income in the Scottish sector. The decommissioning relief problem could also emerge with CT and SC. Currently, decommissioning relief for these taxes can be clawed back to 2002. Much exchange of information between the relevant UK and Scottish authorities would be necessary. A considerable expertise in this tax area would have to be developed within the Scottish government. Other specialised issues would require to be handled after Scottish independence. For example, currently gas is exported from fields in pipelines in what would become the Scottish sector to Teesside and Bacton in England. The pipelines cross what would become the Scottish-rest of UK boundary line. The tax status of the pipelines would require
clarification. Fortunately there exists UK legislation dealing with exports by pipeline. For example, there are exports from the Markham field to Dunkirk and UK legislation exists to deal with the tax and other issues.

7. A specific tax issues relates to decommissioning relief. For PRT the rules are that decommissioning losses in a field are clawed back indefinitely against earlier PRT field profits and tax refunds made. For CT and SC the claw back is permitted to 2002. A complex situation arises when decommissioning takes place after Scottish independence but the claw back period extends to a pre-independence date.

8. Efficient tax policy would require North Sea investors to designate establishments with central management and control based in Scotland to ensure that effective taxation could be levied on the activities in the Scottish sector.

9. There could be a possible need for a tax treaty between Scotland and the rest of the UK and possibly with other countries, such as the USA and Canada, which are the source of important investors in the North Sea.

10. The health and safety issues relating to the UKCS are currently the responsibility of the HSE which is a UK body. If Scotland become independent responsibility for the Scottish sector would presumably have to be undertaken by a comparable Scottish body. A considerable expertise is required to effectively undertake the HSE responsibilities. For a Scottish body efficiently to undertake its work it would be most desirable that a large amount of relevant data be made available to it. Again it should be noted that the HSE has an office in Aberdeen which conducts work relating to the UKCS.

11. Independence would, of course, permit a Scottish government to pursue its own policies in relating to oil and gas in the Scottish part of the UKCS. Thus licensing, taxation and other policies, such as those relating to third party access to infrastructure or encouraging investment in mature fields, could be changed and could vary from those applicable to the rest of the UKCS. The industry is relatively much more important to the Scottish economy than to the rest of the UK. Experian/OGUK have estimated that in 2010 direct and indirect employment from the UKCS totalled 239,000 for the UK and 110,000 for Scotland. Employment induced by the above was estimated at 100,000 for the UK and 41,000 for Scotland. (In addition to the above, export activities attributable to the oil and gas cluster were estimated by Experian/OGUK to amount to 100,000 for the UK and 45,000 for Scotland). These figures have held up well in recent years reflecting the large investment currently taking place in the UKCS. Given the importance of the oil and gas cluster to the Scottish economy it can be expected that a Scottish government would be sensitive to the employment consequences of its licensing, taxation, and other policies noted above.

12. The possibility of Scottish independence has generated much interest in the likely size of the tax revenues which could accrue to a Scottish government. Using financial simulation modelling and a high quality field database the present writer has made estimates of the hypothetical share of the revenues which would have accrued to Scotland in the past had it been independent. The modelling incorporated all the elements of the changing tax system over the years. The data relating to individual
fields were segregated into the Scottish and rest of UK sectors using the median line as the boundary in the North Sea. Allocations of exploration and appraisal expenditures, R and D costs and overhead were made between the two sectors. Estimates had to be made of the relevant R and D costs and allowable overheads for tax purposes. The results of the modelling in terms of absolute tax revenues (at 2009 – 10 prices) are shown in Chart 1. The figure for financial year 2011 – 2012 should be downgraded as a consequence of the large reduction in production and so taxation receipts for that year.

Chart 1

**Hypothetical Scottish Royalty and Tax Revenues from the UKCS**

(£m. at 2009/10 prices)

![Hypothetical Scottish Royalty and Tax Revenues from the UKCS](image)

13. The obvious features of the results in Chart 1 are (a) the substantial absolute sums for many of the years, and (b) the volatility of the amounts raised. To a large extent the volatility relates to the major fluctuations in oil prices over the years, though there are other causes such as the frequent changes to the tax rates, production decreases and the irregularity of capital allowances. The latter is a consequence of the lumpiness of capital investment which has been a characteristic feature over much of the period. To give a perspective on the recent position our modelling estimates that in 2010 the Scottish share of total oil production in the UKCS was over 95% while for gas it was 58%. The Scottish share of total hydrocarbon production (including NGLs) was 80%. The Scottish tax share exceeded 90%. This reflects the much higher value of oil compared to gas. I have not made very recent estimates of the potential future tax revenues which could emanate from the UKCS and their division between the Scottish and rest of UK sectors. This would constitute a substantial research exercise. To indicate the difficulty in projecting even short term tax revenues from the UKCS in Budget 2011 the OBR estimated
receipts at £13.4 billion for year 2011-12 but in **Budget 2012** they were estimated at £11.2 billion.

14. In order to indicate the future possibilities Charts 2-7 show the results of our new economic modelling giving estimates of future oil, gas and total hydrocarbon production broken down by five regions of the UKCS. They do not correspond precisely to the division according to the median line between Scotland and the rest of the UKCS. The Southern North Sea (SNS) and Irish Sea (IS) are in the rest of the UK sector while the Northern North Sea (NNS), West of Shetlands (WoS), and most of the Central North Sea/ Moray Firth (CNS/ MF) are in the Scottish sector. A few fields in the CNS/MF with very modest production are in the rest of the UK sector.

15. In Charts 2, 3 and 4 the results are shown under conservative prices and for screening new developments ($70 per barrel and 40 pence per therm in real 2012 prices). With respect to oil it is seen that the Scottish sector predominates the prospects over the next 30 years. Of cumulative total production for the UKCS of 9.26 billion barrels (bn bbls) the Scottish sector contributes 9.2 bn bbls. For natural gas the total for the UKCS over the 30 years is 3.8 billion barrels of oil equivalent (bn boe) of which the Scottish sector contributes 2.3 bn boe (61%). Total hydrocarbon production (including NGLs) is estimated at 13.36 bn boe of which the Scottish sector contributes 11.8 bn boe (88%).

16. The results under the higher price scenario ($90 per barrel and 55 pence per therm in real terms) are shown in Charts 5, 6 and 7. Total oil production over the 30 years is 11.1 bn bbls of which 10.97 bn boe comes from the Scottish sector. For gas the total for the whole of the UKCS is 5.3 bn boe of which 3.19 bn boe (60%) comes from the Scottish sector. Total hydrocarbon production (including NGLs) from the UKCS amounts to 16.75 bn boe over the 30 years of which 14.54 bn boe (86.8%) comes from the Scottish sector. Production continues beyond 2050 in this scenario. It should be noted that the achievement of these production levels depends on several other important factors, such as the absence of major unplanned shutdowns and the continued availability of infrastructure.

17. The above projections for the next 30 years may be compared with the most recent official estimates by DECC of the ultimate potential from the UKCS. Their central estimate is 19.7 bn boe with a low estimate of 10.3 bn boe and a high one of 33 bn boe. There is no time period attached to these estimates. Total hydrocarbon depletion to date (since production commenced in 1967) is around 41 bn boe.

18. The tax revenues which will emanate from the Scottish sector in the future depend on the behaviour of oil and gas prices, production, investment, operating, and decommissioning costs. My guesstimate is that over the next decade the annual values could be in the £5 billion - £10 billion range. A considerable amount of research work would be required to produce fully-informed estimates, but it can safely be concluded that substantial revenues from the upstream oil and gas sector would become available to a Scottish government, with a strong probability that they would fluctuate over the years. In the long run they will also decrease as production falls, but, as the results of our modelling above shows there could be substantial production for many years ahead.
Chart 2

Potential Oil Production $70/bbl and 40p/therm
Hurdle: Real NPV @ 10% / Real Devex @ 10% > 0.3

Chart 3

Potential Gas Production $70/bbl and 40p/therm
Hurdle: Real NPV @ 10% / Real Devex @ 10% > 0.3

Chart 4

Potential Total Hydrocarbon Production
$70/bbl and 40p/therm
Hurdle: Real NPV @ 10% / Real Devex @ 10% > 0.3

Chart 5
Potential Oil Production
$90/bbl and 55p/therm
Hurdle: Real NPV @ 10% / Real Devex @ 10% > 0.3

Chart 6
Potential Gas Production
$90/bbl and 55p/therm  
**Hurdle: Real NPV @ 10% / Real Devex @ 10% > 0.3**

![Chart 7](image)

**Potential Total Hydrocarbon Production**  
$90/bbl and 55p/therm  
**Hurdle: Real NPV @ 10% / Real Devex @ 10% > 0.3**

19. There has been a revival of interest in an Oil Fund, particularly by the Scottish government. There has always been a sound case for such a Fund. Fundamentally, tax revenues from oil and gas production are conceptually different from other taxes.
such as income tax and VAT. This is because oil taxes emanate from the depletion of part of the nation’s capital stock. Oil and gas reserves form an important part of the UK’s capital stock and their depletion constitutes a diminution of that stock. In order to mitigate this undesirable outcome it is arguable that the economic rents from oil production (collected to the state in taxation) should be invested with the objective of maintaining the nation’s capital stock. If the revenues were invested in a Fund annual benefits could be taken in the form of the income received from the invested monies. The nation could thereby receive benefits in perpetuity from the oil windfall. In retrospect it is regrettable that successive UK governments did not establish an Oil Fund. It could have ensured that the oil revenues were not employed for normal budget purposes but were invested to maintain the nation’s capital stock and produce a yearly permanent flow of income. The benefits of such schemes have become increasingly recognised around the world. The many existing schemes have different rules. In the Alaska Permanent Fund 25% of bonus bids and royalties are paid into the Fund and the government does not have access to the monies. The Fund has a manager and every year a dividend is paid to the permanent residents of Alaska. In Norway there is also a Fund manager who invests the oil monies in securities of various types, generally outside the country. The investments of the large existing Funds around the world are to a considerable extent in financial assets, but investment in real assets are also made. For example, the long-established Fund established by Shetland Islands Council has announced its intention to invest (along with SSE) in the Viking wind farm which has just received planning permission. (It may be noted that in recent years pension funds have also become investors in real assets, including energy utility distribution schemes).

20. There is a sound case for the establishment of a Scottish Oil Fund on the basis of the arguments presented above. It is a mechanism which can ensure that the benefits of oil exploitation are invested rather than consumed. The evidence is that the very large benefits which accrued to the UK government in the first half of the 1980’s were consumed rather than invested. The rules of an Oil Fund should ensure that the monies from the depletion of the reserves are not all consumed. Restrictions on access to the capital (as opposed to the fund income) are thus desirable. There should not be much reliance on the oil revenues for normal budget purposes. Norway discovered this at considerable pain when the oil price collapsed to $10 in 1986. This led to a major rethink of policy which culminated in the establishment of the Oil Fund (now Pension Fund). While it may appear convenient for a government to call on oil revenues for normal budget purposes such temptations should be resisted.

References


October 2012

WEDNESDAY 24 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witness
Professor Alex Kemp, University of Aberdeen

Q548 The Chairman: Professor Kemp, thank you very much for coming and thank you for your very helpful paper, which covered a number of the issues we wanted to explore with you. Perhaps I may start by asking this question: if Scotland became independent, North Sea oil and gas reserves would have to be divided up between Scotland and the rest of the UK, as would many other assets and liabilities. You have suggested that the starting point for the division of North Sea assets should be the median line. Can you tell us the precedent for this and what alternative divisions are conceivable? Why do you refer to the median line as the starting point for those discussions? Are there examples of different divisions in past negotiations on natural resources, or is it mainly the median line?

Professor Alex Kemp: Historically the UK Government and Governments on the other side of the North Sea found favour with the median line. We go a long way back to the 1958 convention on the north continental shelf. That is why I say it is a starting point. It was felt by the UK Government and the neighbouring North Sea countries—Norway, Denmark and so on—that this was a reasonable way to divide up the North Sea. I say “starting point” because it is a negotiation. The starting point in the negotiation is quite likely to be the median line. However, other issues frequently emerge—for example, the status of uninhabited islands. Are they part of the UK or not? Are they just rocks in the sea? The most dramatic example of that was Rockall. In 1972, the UK Government passed the Island of Rockall Act, which stated that henceforth Rockall was part of Inverness-shire. This was to the disbelief of other countries such as Iceland, the Faroes and Denmark, which thought that
it was just a rock in the sea. These are examples of where the median line has been disputed. Some time ago in the late 1960s, West Germany disputed the use of the median line between Denmark and the Netherlands, and went to the International Court, which, to the surprise of most at the time, ruled that Germany was getting too small a share of the North Sea from the use of the median line and drew some other lines. The UK has also had disputes with Ireland over the Irish Sea, and with France over the Channel. A lot of the disputes have been to do with little islands and whether they are part of the median line. In the case of Scotland and the rest of the UK, the median-line principle seems relatively straightforward. There are little islands called the Farne Islands, which could cause issues, if you really wanted to go into the minutiae. More seriously, someone could say that there is an existing line just north of Berwick going straight out into the North Sea which is used for dividing Scottish and English civil and criminal law. Some might say we should use that line, but the median line is established for fisheries management purposes and I should have thought that there would not be too much controversy about that.

Q549 Lord Tugendhat: You have had a great deal of experience of the oil industry all over the world. You have seen a variety of different agreements between contiguous territories. That brings me to ask you about the Northern Isles. We have seen evidence from the two MSPs suggesting that they might seek some distinctive constitutional position. On the basis of what you have seen around the world, would you expect the Northern Isles to seek some kind of special dispensation, either within the remaining United Kingdom or within the newly independent Scotland? Given that a considerable proportion of the reserves lie within their general domain, what do you think would be the parameters of the sorts of agreements that would be reached between the Northern Isles and either Scotland or the rest of the UK?

Professor Alex Kemp: It is a nice debating point but it has not been a live issue. I go to Shetland from time to time. I am asked to give advice on some subjects relating to oil. It has not been an issue for a long time. There was such a debate back in the 1970s where Shetland in particular was expressing some doubt about the wisdom of being part of an independent Scotland. So it is not a live issue at the moment. It is correct that a lot of the reserves in the east Shetland basin are adjacent to Shetland, and are hopefully growing west of Shetland, including west of the Western Isles. Hopefully, they will become quite big. My view is that it is not likely to become a live issue. As far as foreign policies are concerned, there is no good reason to think that Shetland would get a better deal from a London Government than a Scottish one.

Lord Tugendhat: I am not suggesting Shetland would get a better or worse deal; I was wondering whether you felt that it would seek some special deal, either within the newly independent Scotland or within the remaining UK.

Professor Alex Kemp: I repeat the point that it is not a live issue at the moment, but who knows? It is the case that both Shetland and Orkney have their own oil funds, which they set up amid strong opposition from the UK Government and the Scottish Office, as it was then, in the 1970s. Neither was in the least bit enthusiastic that the revenues should be shared by the local governments. They were worried that it could encourage others to think similarly and ask for a share of the revenues as well. It is the case that Shetland, which I know quite well, is conscious of its oil fund and the advantages that it has brought. Of course in more recent years, there have been new developments west of Shetland. The Laggan-Tormore gas will be landed at Sullom Voe. Shetland has requested, and I understand is going to get, some
small royalty on that production. Shetland is conscious of all that, but on a greater scale, I am not convinced. There is no evidence of it at the moment, anyway.

Q550 Lord Forsyth of Drumlean: First, I thank you for the excellent paper that you sent to the Committee, which I read last night. I had not appreciated the complexity. We talk about transferring the oil resources according to some line, however it is drawn, but I had not appreciated that there were huge complexities in terms of, for example, the health and safety and regulatory regimes. When I was the health and safety Minister, I did the case studies following the Cullen report on the disaster. At that time, a single case study cost more than £1 million. Reading your paper, you point out that the whole business of the regulatory regime had to be decided and set up. Regarding the licences, you also point out that, if it were a company, you would get a change of control and you could say, “Hang on a second. We need to renegotiate this”. I do not know to what extent licences would be up for renegotiation. Obviously, the oil companies would try to take advantage of that. The third thing that struck me from your paper was the complexity of the taxation regime, which goes right back to events which would then be in another jurisdiction. Although you point out that a lot of these operations are run out of Aberdeen and Scotland, I wonder whether you have a view on, or an estimate of, what the cost would be of an independent Scottish Government setting up these regulatory regimes and doing the negotiations, and the possible leakage—an unfortunate phrase—of revenue arising from the fact that everything is being thrown up in the air. Also, do you have a view on the possible consequences, in terms of the safety regime, of having to move to a new regulatory regime? I know that that is a really big question but your paper prompted these thoughts.

Professor Alex Kemp: In the paper I did indeed highlight what we might call transitional problems. There will be transitional problems in relation to the economy but, with respect to North Sea oil and gas, there are certain characteristics of the industry which mean that a lot of attention has to be given to the transition. With regard to licensing, a Scottish Government would have to establish departmental expertise in licensing. To do efficient and effective licensing would require them to be knowledgeable about the historical process involved when licences were awarded and when field development plans were approved and all the gradations pertaining to that, so that they would be in a position to assess how well the companies were doing in relation to their policies, exploration programmes, development plans, et cetera. That would require the transfer of a lot of data and acquisition of knowledge, which currently resides in the Department of Energy. It is true that physically quite a bit of it, but not all, is in Aberdeen.

On tax, the expertise is currently with a specialist division of HMRC. Again, the issue is that, to assess the tax position of all the licensees, you need a knowledge of history because it is all about fields being explored for development, hopefully over a long period. There will be various tax allowances that will be carried forward to assess how much tax we should be paying this year and next year. Again, there will be a need to acquire knowledge and set up a specialist unit. To be effective, there would need to be the transfer of a lot of relevant data from HMRC in London to Scotland. With respect to the HSE, again we have a UK agency policy based on the safety case. But again, in order to assess policies, expertise would have to be developed by some body corresponding to the Health and Safety Executive. These are transitional problems but of course they can be overcome—I am not disputing that. I am just saying that, if we are looking at the oil and gas sector, my conclusion, if independence comes about, is that investors and Government would have to think about it much more.

In respect of your question about whether companies would seek to renegotiate licences, the answer is that they might. The obvious thing for a Scottish Government to do with
existing licences which still had 20 years to go would be to honour them in order to save a lot of disruption. For new licensing, they would develop their own policies. Those are the particular transitional issues that I wanted to raise with you.

Q551  **Lord Forsyth of Drumlean**: Just to press you on that, I know nothing about how these licences are written, but can they just be transferred? They are agreements between two parties—the oil companies and the British Government.

**Professor Alex Kemp**: Yes.

**Lord Forsyth of Drumlean**: If the Government say, “Well, actually, we’re moving them to somebody else”—the Scottish Government—does that not trigger the possibility of renegotiation of the licences? The specific question I asked was about the cost of doing this—not just the cost to the taxpayer, which will be in Scotland, but to the companies concerned. They will have to deal with a new regulator, which may have a different view on what the appropriate safety case regime will be, and there will be all the uncertainty. Have you estimated what the costs might be, as well as the opportunity costs? They might say, “Do you know what? The North Sea is such a shambles at the moment that we don’t know what’s happening. We’ll go somewhere else.” Are there opportunity costs as well?

**Professor Alex Kemp**: There will be some costs for the investors. For tax purposes, they will have to establish central management and control—that is the nice phrase used—within the country where the tax is being levied. They would have to establish that in Scotland to ensure that a Scottish Government could tax them effectively. With regard to all the other licensing issues, it is indeed conceivable that investors would want to reopen some clauses and ideas. Again, if a Scottish Government had, let us say, any sense, they would aim to prevent that big disruption. So these are the key points.

Q552  **Lord Hollick**: I have two questions. Perhaps you can help us with understanding the importance of the oil sector to the Scottish economy in terms of investment and direct and indirect employment today. Looking to the future, can you give us your assessment of how current extraction rates will decline and over what period of time? Having regard to some new technologies that have been developed in United States to extract more, at what point in your estimation do the extraction rates fall to a level when it becomes economically problematic?

**Professor Alex Kemp**: On the importance of oil and gas to the Scottish economy, the most readily available data relate to employment—I have the figures for 2010. Direct and indirect means the oil companies plus all the supplying team, which is 110,000. Induced means when all the people directly and indirectly employed spend money in pubs and hotels and so on, which is 41,000. Exports from the oil and gas are 45,000. So for 2010 it is 196,000. It has probably grown a little since then because there has been very high investment in the past year, this year and next year. So that is very substantial. In parentheses, I should say that the oil and gas supply chain has been a big success over the last number of years when other sectors of the Scottish economy have not been performing well. To give a little history, the big success has been that the oil and gas cluster has become internationally competitive. Subsea technology developed in the North Sea is now exported to a large number of countries, such as offshore in West Africa and the Gulf of Mexico and onshore Russia, Azerbaijan and so forth. At the moment, of the turnover of the Scottish oil and gas cluster, which is the supply chain, about 45% is now exports.

To come to your other question about the North Sea declining, the new paper that we are publishing shortly, which I managed to get into the memorandum for you, shows that oil
production will come up a bit in the next few years—it has been very low recently—but will then go into terminal decline, although it will last a long time. Our own modelling shows that some fields will last until 2050. From the point of view of the supply chain, there is good reason to think that the export growth will continue. We have good data collected since 1997. There has been continuous growth in export turnover for quite some time. I think we have good grounds to believe that, when the North Sea does go down, there will be some replacement for all that by further growth in export markets. A long time ago—as you said, I have been studying this industry for a long time—it was thought that when the North Sea started to go down, the big multinationals would withdraw to other areas. I do not just mean the oil companies but the big supply companies, such as Halliburton and so forth. They will withdraw to other areas that are growing faster. That has not happened. The interesting point is that the supply chain based in the north-east of Scotland, but including some in the central belt, has continued to have headquarter-type operations, which service other markets such as West Africa, which has grown strongly, Brazil and the Gulf of Mexico. Why is that? The answer is that there is a big cluster now. The cluster has reached a critical mass, so the ancillary services that Halliburton and its equivalents would need are around them as well. As long as there is some activity in the North Sea, albeit in decline, there is reason to believe that, because of the expertise in the cluster, exports will continue to flourish.

Lord Hollick: So by 2050, the oil and gas extraction will be economically low.

Professor Alex Kemp: Very small.

Lord Hollick: But the industries that have been created could well have a life after that because of the cluster effect you describe.

Professor Alex Kemp: Well, 2050 is rather optimistic, but if we are talking about 2020 or 2030, I would be happy to say that we will still have quite a big, active supply chain. There is a big debate about how the world oil and gas industry will grow over such a long period. Some think that it will continue to grow to 2050, but certainly it will continue to 2020 and 2030 or so, and that gives opportunities for the supply chain. The reason why the supply chain in the north-east of Scotland has become internationally competitive is that they brought in subsea technologies at an early stage. They developed these techniques at quite an early stage, and now subsea is becoming common all over the world. At Aberdeen airport you find people flying off to Angola, Nigeria, the Gulf of Mexico and Brazil and nobody thinks anything about it. That kind of thing could continue for, let us say, 20 years, but I am not sure about 2050.

Q553 Lord McFall of Alcluith: Professor Kemp, you mentioned the complexity of the tax charges on capital allowances. Notwithstanding that, could you give us an idea of the net tax revenues from oil over the next five to 10 years?

Professor Alex Kemp: In my memorandum, I had a chart where I gave the results of studies that we have done in the past to assess the hypothetical shares attributable to the Scottish sector using the median line. You can see that they would have been very big in the first few years in the 1980s. We are talking about very profitable fields and big tax revenues as well. In more recent years, they have fluctuated a lot. That is the obvious feature. They have gone up and down in relation to changes in tax rates but also in oil prices and allowances for tax. Right now we have several very big fields being developed. They will get capital allowances on a 100% first-year basis. That will reduce taxable income for the next two to three years.

I did two studies in the past. One was financed by the Economist, the other by the Scottish Government. To do a study that produces results of which I could feel proud requires quite
a lot of intricate work. I can explain it. We have a very good field-based model. But to get the tax payments, you need other miscellaneous costs, such as exploration appraisal costs, overheads that were not directly attributable to the field but are not tax-deductible, like R&D costs—a lot of things like that where you would have to allocate them between the Scottish sector and the rest of the UK. A lot of judgment is involved. When we did the historic, we had the comfort of being able to check against the UK-published tax revenues. I was comfortable about the results because we modelled separately and checked against the UK. Going forward, we will not have that check. The budget document does indeed give some round numbers for five years. However, I have said that without doing a lot of intricate work which is really quite time-consuming I can make a guess that for the Scottish sector it could range annually between £5 billion and £10 billion per year for the next decade. Factors that will determine whether it is up to £10 billion or down to £5 billion are the behaviour of the oil price and the behaviour of production. The past two years have been very bad, but we are fairly confident that oil production will come up again. It will take a year or two. Other factors are tax rate and tax allowances. As you probably know, there have been quite a few changes to tax allowances over the past couple of years following the increase in the Budget in 2011. All those affect revenues, so for Scotland I am prepared to say between £5 billion to £10 billion per year for the next 10 years.

Q554 Lord McFall of Alcluith: What credibility do you give to the contribution to our Committee that says that Centrica, which owns British Gas, has claimed that a mere 14% of North Sea oil and gas areas are located in Scottish waters, with the rest falling in English, Norwegian and Dutch territories?

Professor Alex Kemp: One investor was particularly looking for gas and to have their own gas. Prospectively the UK for some years now has become more oil-prone than gas-prone. I have a chart in my memorandum showing prospective gas and oil production, and gas production goes down quite steeply. If you are looking for gas, the UK compared to Norway is less prospective as things stand, unless you are prepared to go west of Shetland, as some investors are—but some are not so keen, because it is very high cost. The oil has been the driver in recent years and in our modelling it will be the driver for the next few years. Of course, there will be gas fields, but in terms of size, they are not quite so big. Just to add to that, one sobering fact is that in the southern gas basin, which was the first region developed, in the first nine months of the year there was no exploration.

Q555 Lord Forsyth of Drumlean: Just on a point of information—and this is really complicated—the number you gave before Lord McFall’s question is a net number. For a Scottish Government in an independent Scotland with all these oil fields, it is comparatively easy to make an estimate of how many barrels of oil come out and the oil prices. That is the number that is often used in public debate, but is there a number that represents the liabilities in terms of the tax regime and other liabilities that occur? Is there a global number? You are getting the asset of the North Sea oil resources. Yes, they may provide a revenue stream based on the oil price and your estimate of the likely extraction rates, but on the other side of the balance sheet there is another number, which is what you have to pay back in tax release to the companies, which go back a long way—as well as clean-up and other costs. Can you give us a global number for what that is? What is on the liability side? Everybody always looks for the revenue.

Professor Alex Kemp: The costs are very high, there is no question about that. Over the last 10 years, the oil price has gone up but the costs have more than doubled over the past eight years. For a new field development, on average we are talking about development costs
of $19 per barrel and lifetime operating costs of $13 per barrel. That gives you a flavour; that is the average, but the range can go very much higher than that. Right now this is having an effect. The OBR in Budget 2011 estimated tax revenues of £13.4 billion for the whole of the UK. This year it had to downgrade the estimate to £11.2 billion. The price had not come down. New investment is going in now, in very expensive fields west of Shetland. The allowances are provided 100% the first year—that means, right away. The taxable base goes down because of that. So there was a big unexpected short-term reduction because, first, that production went down. We now have quite a few fields that are very old; one-third of the platforms are more than 30 years old, and we have had quite a few unplanned shut-downs because of that and the ageing infrastructure. These were the two factors that led the OBR to reduce its estimate for 2011-12 by such a big magnitude. So you are right that the costs are very high, and we should not be lured by the price of $100 per barrel.

Q556 Lord Levene of Portsoken: Given the volatility of net tax revenues, this would translate into volatility in the budget deficit, at least in the early years. What does that imply for the budgetary process? Is the main source of the volatility the oil price volatility? Would you expect that to make fiscal policy more difficult? Would you argue in favour of a non-oil fiscal target for the future?

Professor Alex Kemp: As I said, the volatility recently has been due to the oil price fluctuation. Secondly, on allowances for costs, at the moment a number of fields are being developed at the same time. There is coincidental development of a number of fields. That reduces the tax base a lot. It is just part of how things are in the oil industry; if a company makes a good discovery it will develop it when it feels that it is most appropriate, and others may also make discoveries—and if they develop at the same time, the costs are higher. By the way, there is a cost push as well; there is a big element of that right now.

From the point of view of the Government, I have argued for many years that it is not very wise, and not very good economics, to rely on oil revenues for normal budgetary purposes. That applies to a UK Government or a Scottish one. That is partly because of the volatility. The chart shows that the numbers can change a lot in a very short time. But it is also because it is conceptually unsound. Oil revenues are different from income tax, VAT and national insurance, because they come from the depletion of a natural resource that is non-renewable. Those reserves are part of your capital stock—you are rapidly consuming your capital, so you should ensure that the net profits and the tax on these profits are invested and not consumed. For a normal budget, that is what normally happens. We had a big debate about that in the late 1970s, although the debate was not really very scientific because, although the idea of an oil fund had some merit, it would have enabled all the spending departments to go and spend some more. The idea is that you do not do that. You put it in a fund to ensure that the capital stock of the nation as a whole is maintained. You can invest the fund and you can have a big party with that—you can have permanent consumption out of that. But consuming your capital is not good economics anyway, although most Governments have not appreciated that.

Q557 Lord Levene of Portsoken: Can I just try to understand that? You said initially that when new developments were going on you would expect the revenue to decrease.

Professor Alex Kemp: Other things being equal, yes.

Lord Levene of Portsoken: Is that because the companies would be spending on that development and accruing less, expecting it to come in at a future date?
Professor Alex Kemp: Yes, in the North Sea system, if you spend £100 this year, you will get a tax allowance right away. It is not spread over 10 years. At the moment we have five big fields being developed, just by chance. There is no good reason why five are happening at the same time. So these tax allowances will be very big this year, next year and the year after, and even though the oil price is $110 it will still have an effect.

Lord Levene of Portsoken: So the more attractive you make it for the industry to come in on a tax basis, the less you can expect to earn during the period.

Professor Alex Kemp: You will get a payback after that.

Lord Levene of Portsoken: But in the immediate term, you will suffer for it.

Professor Alex Kemp: Yes.

Q558 The Chairman: You touched on the oil fund, so I come on to that. You probably heard what Mr Peat said earlier about the prospects for an oil fund. I suspect that he was taking a political judgment that, given the likely heavy public expenditure issues that the Government face, they would not want to see a diminution of oil revenues during that period, which an oil fund, in the short term, at least for the next five years, would create. Do you not think that for all the theoretical merits of the fund, which you have put forward and which I fully understand, that is the likely practical implication and result: that an oil fund would be rejected, certainly in the near future, for up to 10 years? Have the Scottish Government given any indication what their policy would be on that?

Professor Alex Kemp: Well, first, the reason that I introduced a nice paper in 2009 about the concept of an oil fund is that it was nicer in Britain. That is one thing. If you are a Government with a budget problem, that is a different thing. I do not have specialist knowledge of the overall British position, but I read what is publicly available. In the current and likely circumstances, it would be difficult for a Scottish Government to hypothecate away all the oil revenues into a separate fund. I can well see that. That is exactly what happened in 1978 and 1979. We had a debate about that but the Treasury said, “No, we need the money to reduce the public sector borrowing requirement, pay back debts,” and all that. So we did not actually do well out of the oil revenues when they were used. Of course, it is a matter of judgment, but when we had huge revenues, the money was used to help public consumption at a time of very high unemployment. That is fine as a concept, but from the point of view of maintaining the capital stock of the nation, it was not.

The ONS produces every year what it calls an environmental account. It recently published one. It has what it calls an oil and gas monthly balance sheet. That says, “You have produced the oil now, so the reserves are down: what is the loss of value net of all the costs and everything?” In 2010, the last year for which it has data, it put the loss of value on the balance sheet at £11.6 billion. That is the concept. In practical reality, it is very tempting for a Government to dip into this. In some countries, they provide legislative constraints on that. Alaska has a permanent fund. It does not put all its oil revenues into it, only 45% of bonus bids and royalties, so by no means the whole lot, but it is made quite clear that those moneys will not be available for the government budget and are invested in a portfolio of assets. The income comes back and, every Christmas, a permanent resident of Alaska gets a cheque.

The Chairman: I understand the advantages, but have not the Scottish Government made pronouncements on what they would do if they were independent on the issue of an oil fund?
Professor Alex Kemp—Oral evidence (QQ 548-563)

Professor Alex Kemp: They have certainly made a clear statement that they would establish one, yes. They produced a substantive paper in July 2009 on the concept and their intention.

The Chairman: So, looking ahead, it is not really an issue that we should take into account in our calculations and our expectation of the cost.

Professor Alex Kemp: Well, I cannot say what they will do, but they have repeatedly said that they have serious intentions of setting one up.

Q559 Lord Forsyth of Drumlean: In your very excellent paper, you make the case for the oil fund. That may well have been a good idea back in 1978 but now, given the budgetary position, for the Scottish Government to set up an oil fund is a bit like somebody who is running up an overdraft wanting to set up a pension fund. All you do is make your overdraft larger. You make very convincingly the economic case that you are in effect consuming capital assets. What I cannot get my head round is that, given that an independent Scotland will have to take a share of the national debt, and given that the national debt at the start of this Parliament was about £1 trillion—everybody talks about the budget deficit, but the debt by the end of the Parliament will have increased by nearly 50% to £1.5 trillion, so the national debt will have gone up by £500 billion—why would you want to use the resources, even if you had the spare capacity, to put them in an oil fund rather than to reduce the overall level of indebtedness of the country, which would have the same effect, according to your argument, of improving the balance sheet of the country? I cannot understand why a Scottish Government would want to say, “Here is an oil fund”, when they would be faced with a huge part of what is a growing national debt, which neither Government, on either side of the border, appear to be able to prevent continuing to grow.

Professor Alex Kemp: I am quite aware of all these temptations. The emphasis on debt that you made reminds me of the argument used by the Treasury. I remember Nigel Lawson talking about it. We are talking about the very early 1980s, so there was a very big public sector borrowing requirement. We had very big oil revenues. He argued that the best way to use them was to reduce the public sector borrowing requirement. That, in turn, would reduce interest rates and encourage investment, and that would mean future generations benefited. That was the argument in a nutshell. As a statement, it seemed quite reasonable. The only thing was that it did not quite happen. Investment did not go really up; it was public consumption that went up, for a good reason—we had very high unemployment. The danger is, if you do not do something like that, it is very easy to use the revenues from the oil for what you might call normal budget purposes such as debt reduction, rather than take more painful decisions, which would be moderating public expenditure or increasing other taxes. Taxing the oil industry from a political point of view is often easier than having a decline in public expenditure or increasing other taxes.

Q560 The Chairman: Perhaps I may come back to costs, specifically the costs of decommissioning the oil rigs. I think that you have suggested that that could come to around £30 billion over coming the years. If Scotland were to choose to become independent, would it pay for that cost, what are the plans to create provision for it and are there other costs, such as tax losses, that would be carried forward and set against other businesses?

Professor Alex Kemp: The decommissioning costs are indeed likely to be £30 billion. We are producing a new paper in about two weeks, and we are looking at over £30 billion over the next 30 years. The obligation is on the oil company licensees; they are the ones that have to do the work and pay for it. It is not any Government directly. However, all the costs, like any other legitimate business costs, are deductible against the income of the
companies. That is how it works. At the moment in the tax system, rather more than 50% of the costs would fall on Governments in the form of net tax reductions to the companies. It is quite a lot of money and it comes when the income from the field in question has stopped. There are complicated rules for dealing with that. The UK Government are very worried that companies could go bankrupt, renege or disappear, so there is joint and several liability. With the special petroleum revenue tax, you claw back the decommissioning losses against the tax that you have paid in previous years. On these big oil fields that the petroleum revenue tax refers to, you can claw back for quite a few years. For corporation tax, you can set it against any other income that you have now, but there is a provision to claw back the losses that were incurred until 2002. In brief, all these costs are tax-deductible. Averaging out, rather more than 50% will result in net tax reductions to the Government. That is how it works. It is quite complicated in practice. One complication has been pointed out: if Scotland became independent some years from now and wanted to claw back corporation tax until 2002—that is before independence—that would be quite a complicated thing to resolve.

Q561 The Chairman: That is exactly the supplementary question that I was going to ask you. It would be an extraordinarily complicated issue to decide how to share that out between an independent Scottish Government and the UK Government, given that that would straddle both the period when Scotland was part of the United Kingdom and the period afterwards.

Professor Alex Kemp: In practice, how to deal with that might have to be part of an agreement. If fields were transferred from the UK Government to the Scottish Government and then decommissioning came some time later, clawing back against the period when it came under the UK Government would be very difficult. Would they have the books? I guess that it would have to be part of an agreement. That just shows the complexities.

The Chairman: The only thing that this Committee could flag up is that this is a big issue because there are big sums involved.

Professor Alex Kemp: Quite big sums would be involved, yes, spread over a long time. When we talk about £30-odd billion, we are modelling for the next 30 years.

Q562 Lord Forsyth of Drumlean: Very quickly on that point, Alex Salmond has said publicly that the costs of decommissioning would have to be met by the UK Government, but on your analysis that is not something that should be delivered because the oil companies would be operating in an independent Scotland and would expect these reliefs. If the Scottish Government were not going to pay these costs, they would have to remove the reliefs, which would be to the disadvantage of the oil companies. Would this not create great uncertainty for the oil companies in relation to investment?

Professor Alex Kemp: The idea of removing the reliefs would be very alarming. In the 2011 Budget the UK Government increased the supplementary charge from 20% to 32% so it is a profit tax. However, you will not increase to 32% the rate at which you get relief for the commissioning. That sounded big alarm bells and the result was a big debate. The most recent position on that is that the UK Government have seen the merit of making a change like that and have issued a discussion paper about giving guaranteed certainty on decommissioning relief. There is a Treasury consultation paper that is live right now. A Scottish Government, if they were wise, would have to honour that, otherwise there would be a big negative effect on investment sentiment.
Q563 Lord Tugendhat: As I understand it, Professor Kemp, an independent Scotland would have a trade deficit with the rest of the UK. Would you see oil exports as being directed primarily at the rest of the UK in order to balance that deficit, or being directed elsewhere? If elsewhere, given the moves towards self-sufficiency in North America, and given the continued pressure from Russia to export oil because its economy is so dependent on it, where would you anticipate the exports going?

Professor Alex Kemp: From the point of view of the balance of trade, oil exports would be a big plus for the Scottish economy. If Scotland were part of the EU, there would be an obligation not to discriminate against EU partners on exports. It would depend on the open market as far as Europe was concerned. One point is worth bearing in mind. Although it is a big plus for Scotland, it would help the rest of the UK as well. If Scotland were in the sterling area, it would help sterling as well, as there would be a need to acquire sterling to buy the oil.

The Chairman: Professor Kemp, thank you very much indeed. It has been a most helpful discussion and we have benefited greatly from your expertise and your very illuminating paper. I am most grateful.
Johann Lamont—Written evidence

Introduction

1. My name is Johann Lamont MSP. I have been leader of the Scottish Labour Party since December 2011. I have represented the constituency of Glasgow Pollok since 1999, when the Scottish Parliament was first established. I was appointed Deputy Minister for Communities in the Scottish Executive in October 2004, later becoming Deputy Minister for Justice in November 2006, a position I held until the 2007 election. Following a review into the organisation of the Scottish Labour Party, I became the first overall leader of the party in Scotland.

2. My opposition to Scottish independence is based on economic, social and political considerations. However, as the work of the committee is focussed on the economic implications of Scottish independence for the UK, I have limited myself to questions on the following issues: (i) division of the UK’s public liabilities and assets, with a focus on national debt, public sector pensions, bank exposures arising from the UK Government’s interventions in the financial sector, North Sea oil, defence infrastructure and equipment, and the gold reserves; (ii) the potential repercussions of separation for the currency, monetary policy and financial regulation; and (iii) fiscal policy and taxation.

3. I welcome the opportunity to comment on this wide-ranging select committee inquiry, and I hope this submission informs what I consider to be a highly important programme of work.

Division of the UK’s public liabilities and assets

National debt

4. To answer the question of how UK national debt should be divided in the event of Scottish independence, it is necessary to first resolve the following questions:

- What do we mean by national debt?
- What is the size of UK debt? and
- How would an independent Scotland’s share of UK debt be calculated?

5. National debt can be measured in a number of ways. Firstly, Public Sector Net Debt (PSND) provides the most straightforward method of measuring UK debt. PSND is calculated as financial liabilities (mainly gilts, Treasury bills and National Savings liabilities) minus liquid assets (mainly foreign exchange reserves and cash deposits) with both scored at face value. However, PSND is a limited measure of debt, as it excludes future liabilities from past Governments, including public sector pensions and PFI liabilities. Since September 2008, the ONS has used a second definition of PSND, which excludes the “temporary effects” of the UK Government’s interventions in the financial sector. At the end of March 2012, PSND, excluding liabilities accrued from interventions in the
financial sector, was £1,022.5 billion, equivalent to 66 per cent of GDP. For simplicity, when referring to PSND for the remainder of my submission, this will be in reference to the measurement excluding UK Government financial sector interventions. I will deal with the issue of how bank exposures should be divided, in the event that Scotland became independent, separately.

6. A wider measurement of UK debt is contained in HM Treasury’s Whole of Government Accounts (WGA), which takes account of net public service pension liabilities, commitments under PFI contracts and contingent liabilities. According to the Treasury’s WGA Unaudited Summary Report for the year ending 31 March 2011, published in July 2012, the net value of future public service pension payments was £960 billion; total capital liabilities, arising from PFI contracts, stood at £32 billion; £108 billion was liable in “provisions” (representing the estimation of liabilities for expected future expenses, such as nuclear decommissioning, that have been discounted to present value); and there was £15 billion in unamortised premium or discount on gilts liabilities.

7. At the end of March 2011, net UK liabilities – including PSND and other public sector liabilities – amounted to approximately £2,020 billion (excluding financial sector interventions).

8. There are, as I see it, four basic methods of calculating the proportion of UK debt that would be allocated to an independent Scotland. These are by (i) share of population, (ii) percentage of GDP or GVA, (iii) proportion of public sector spending, or (iv) share of public sector employment. The Scottish Government has not been clear about its favoured method of calculation, though it must be suspected that they will prefer allocating UK debt on a per capita or GDP/GVA basis, as these are proportionately smaller than Scotland’s public sector spending and employment levels.

9. Given the high level of liabilities that would in all likelihood be taken on by an independent Scotland, I have concerns about the ability of a newly sovereign state to service its debt. These projected figures – which do not take into account bank exposures – are of deep concern. This, in a sense, is the key point: if an independent Scotland was unable to make its debt commitments, there would be severe economic ramifications for the wider UK.

10. The Scottish Government, I suspect, operates on the basis that debt could be serviced by issuing bonds and Scotland possessing a AAA credit rating. Such an assumption needs to be treated with a healthy dose of scepticism. As a newly independent country, with no credit history, it is highly likely that Scotland would find itself in difficulties with the bond markets. It should not be taken for granted that Scotland could borrow at a similar cost to the present UK Government. I draw attention to oral evidence, given to the Treasury Select Committee on 24 April 2012 by David Riley, Director of Fitch, one of the “big three” credit rating agencies (along with Standard & Poor’s and Moody’s). He said: “I am not aware of any situation where we have awarded AAA rating to a newly independent sovereign nation.”

The Committee may also wish to note that

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33 Public sector net debt was £905.3 billion (60.5 per cent of GDP) at the end of March 2011. The figure is calculated by adding PSND in March 2011 with other liabilities contained in HM Treasury’s Whole of Government Accounts in the same month.
34 Treasury Select Committee, Uncorrected transcript of oral evidence, (24 April 2012)
Moody’s sovereign bond rating methodology states that countries will be marked down if they do not have a long record. Moody’s methodology states: “Immature economic and political institutions increase the risk of unpredictable behaviour in times of stress, inviting negative credit implications.”

11. If downgraded, Scotland would be forced to pay a greater interest rate on its debt than the UK does at the moment. If the borrowing costs of a separate Scotland increased, debt repayments would rise and force the Scottish Government to either cut public expenditure or increase taxes.

12. Even though an independent Scotland would in all probability have great difficulty in servicing its debt, I am absolutely clear that this should play no role in the division of liabilities. An independent Scotland would have a moral obligation to accept a proportionate share of UK debt. The appropriate level of apportioned debt would be subject to intense discussion. I find it inconceivable that a UK Government would simply accept a division based on a per capita or GDP/GVA basis: this would be an independent Scotland’s opening position in negotiations, not the final outcome. Scotland would have to take on more than a proportion of PSND. It would be incumbent upon an independent Scottish Government to take on a percentage of other liabilities, not contained in the PSND measurement, such as those relating to public sector pensions and PFI.

Public sector pensions

13. The division of public sector pension liabilities, in the event of Scottish independence, is an issue that has received insufficient attention. Different experts have projected different figures on pension liabilities. At this stage, given the early nature of research into this area, I do not wish to endorse one particular forecast. I am, however, certain of two things. Firstly, an independent Scotland would have to accept a proportionate share of pension liabilities. Secondly, the amount that would be taken on by an independent state would form a significant proportion of total liabilities.

14. Lesley Sutton, in a publication for the David Hume Institute, entitled Issues Facing an Independent Scotland – Scotland’s Share of UK Public Debt, estimated that the Scottish Government’s liabilities for public sector pensions would be in the region of £112 billion. This was calculated on the basis of WGA data and using Scotland’s share of UK public sector workers to pro rata the total UK public sector pension liability.

15. More recently, arriving at a roughly similar conclusion, Professor David Bell has calculated that an independent Scotland’s share of UK public sector pension liabilities would be £102 billion. Although slightly lower than Sutton’s estimate, Bell concluded that this would still “impose a substantial fiscal burden on an independent Scottish Government.”

16. A related issue that has received inadequate consideration is the liabilities a separate state would have for the pensions of individuals employed in the public sector in Scotland working on reserved matters. Examples include civil servants employed by the

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35 See Chris Giles, “Doubt cast on any future Scottish sovereign rating”, Financial Times, (5 February 2012)
Department for International Development and Department for Work and Pensions – in addition to officials in the Scottish Government, who, although they work on devolved matters, are employees of the UK civil service. The vast majority of these individuals are members of UK-wide defined-benefit pay-as-you-go schemes.

17. The pension contributions of public sector workers that provide services to the Scottish population, but who are employed by UK institutions and contribute to the funding of public sector pensions, needs careful examination. If Scotland became independent, I believe it would have to take over the provision of pensions for those employed in providing services in reserved areas. Professor Bell suggests that it is not clear whether these pension schemes would have a different balance of assets and liabilities from their UK equivalents. As this would take a long-time to establish, Bell concludes that the “most plausible strategy would be to continue with existing rates of contribution from employers and employees.” I am in agreement with this conclusion.

Bank liabilities

18. In order to secure the financial sector, the previous Labour Government undertook a series of recapitalisations of UK banks during 2008 and 2009. In total, this involved capital injections of over £45 billion in the Royal Bank of Scotland (RBS) and over £20 billion in Lloyds Banking Group, which was created following the merger of Lloyds TSB and HBOS. As a result, the UK Government became a significant shareholder in RBS and Lloyds TSB, holding a respective share of 82 per cent and 40 per cent in each. Bank liabilities, it is important to underline, largely represent guarantees against default extended by the UK Government, rather than actual debt.

19. In an interview with Channel 4 News on 11 January 2012, Alex Salmond, the First Minister, said that an independent Scotland would not take on any of the debt associated with the Treasury’s interventions in the financial sector, including in relation to RBS and HBOS. Mr Salmond argued that an independent Scotland would not be liable because the Treasury collected tax revenues from these institutions and failed to regulate the industry properly. In contrast, I believe an independent Scotland could not avoid taking on a share of bank liabilities for these two institutions. RBS and HBOS are Scottish banks that are located in Scotland and the decisions that led to their near collapse were made in Edinburgh. Moreover, I would draw to the committee’s attention the fact that Mr Salmond encouraged RBS to purchase the Dutch bank, ABN-Amro. In the lead up to the takeover, Mr Salmond wrote a letter to the then CEO of RBS Group, Fred Goodwin, promising “any assistance my office can provide” and wishing “good luck with the bid.” The acquisition of ABN-Amro was the deal that effectively broke RBS. The FSA Board report, *The failure of the Royal Bank of Scotland*, described this deal as “a gamble.”

20. The Scottish Government’s position on the division of bank assets is unclear. In September 2012, contradicting the First Minister’s previous statements on this matter, John Swinney, the Cabinet Secretary for Finance, Employment and Sustainable Growth,  

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38 ibid., p. 96
conceded that an independent Scotland would have to take on a share of the liabilities of RBS and HBOS. Mr Swinney, however, declined to elaborate on what share of the banks’ liabilities he expected Scotland to support. 42

21. The UK Government would expect, rightly, an independent Scotland to take on a proportionate share of bank liabilities. This would form a key part of any negotiating process.

22. An important related question is whether an independent Scotland would have been able to bail out RBS and HBOS. I strongly suspect that this would not be the case. Iceland’s banks’ assets were around 7.7 times the country’s GDP. 43 The assets of the three main Irish banks were equivalent to 2.6 times the size of Ireland’s GDP. 44 In Scotland, the total bank assets of RBS and HBOS represented a ratio of over 20 times Scottish GDP in 2008. It seems questionable whether an independent Scotland could have survived the financial crisis without any assistance from the UK.

North Sea oil

23. The division of North Sea oil assets would be determined following an intense (and, I suspect, protracted) period of negotiation between an independent Scotland and the rest of the UK. In the event that agreement could not be reached, the matter would have to be resolved in the International Court.

24. Oil revenues, in all likelihood, would be divided according to a “geographical” share. However, the proportion of North Sea oil revenue accrued by an independent Scotland would be subject to agreement on where the line on the UK Continental Shelf (UKCS) should be drawn. There is also an issue surrounding the future of Orkney and Shetland, which might opt to remain part of the UK, thereby substantially reducing the proportion of oil revenue going to an independent Scotland.

25. The Scottish Government take the view that North Sea oil revenues should be divided according to a “geographical” share. Their assumption is based on the “median line” of the UKCS – a dividing line, roughly speaking, stretching north-east from Berwick-upon-Tweed. On this basis, Scotland would acquire approximately 90 per cent of North Sea oil revenues. I personally believe that such a dividing line should not be assumed. Divergences from the “median line” principle, including in adjudications made by the International Court, have occurred in past settlements. Discussions on where to draw the line would also form part of a wider negotiating process – therefore, any deal on oil revenues might form part of a wider agreement on, say, an independent Scotland’s right to retain sterling as a unit of currency.

26. If Orkney and Shetland decided to remain part of the UK, as Professor Peter Rowthorn pointed out in his evidence to your committee, this would reduce an independent Scotland’s entitlement to North Sea revenue by 30 per cent. 45 Accordingly, if Orkney and Shetland were to remain within the UK, an exclusive economic zone would be drawn around them. This would give the UK control over part of the North Sea that

42 Helia Ebrahimi, “Scotland could take on state bank debts”, Daily Telegraph, (23 September 2012)
44 ibid.
would, under a “geographical” share agreement, otherwise be under Scottish control. The exact boundaries of such a zone would have to be settled by negotiation between the parties involved.

27. Furthermore, it is worth noting that Centrica, which owns British Gas, has claimed that a mere 14 per cent of North Sea oil and gas areas are located in Scottish waters, with the rest falling in the English, Norwegian and Dutch territories – such viewpoints indicate there is great ambiguity on this issue and any claims made by the Scottish Government require detailed scrutiny.46

28. I believe that the Scottish Government over-estimate the long term revenue from North Sea oil and gas and underestimate the unpredictable nature of this resource. The assumption that North Sea oil and gas revenues will grow to £13.4 billion per year is based on an historical spike in 2008-9. The following year oil and gas revenues dropped to £6.5 billion. Oil production, moreover, is steadily declining and is likely to fall below 1 million barrels a day in 2012, compared to 3 million barrels in 1999. In 2011, production dropped by 30 per cent in contrast to the previous year and has fallen on average by about 6 per cent a year over the past decade. Any shortfall in budget revenue from North Sea oil and gas would have to be compensated through higher taxes, lower public spending or more borrowing at a higher premium than the UK. As oil revenues would from approximately 18 per cent of Scottish GDP, any fluctuation in prices could lead to deep cuts in planned public expenditure.

29. When considering the economic implications of independence, it is imperative that the committee also examine “hidden liabilities” associated with North Sea oil. Oil & Gas UK have estimated decommissioning oil installations will cost more than £30 billion by 2040.47 At present, more than half of the cost of this decommissioning will be met by HM Treasury through tax relief.

30. The Scottish Government argues that even following independence most of the cost of decommissioning in Scottish waters would be met by the UK Government. On 17 April 2012, when giving evidence to the House of Commons Energy and Climate Change Select Committee, Mr Fergus Ewing, the minister for energy, enterprise and tourism, argued: “given that the UK has received substantial revenue from these rigs, it seems correct that the UK has a moral and certainly a legal obligation to be responsible for the decommissioning of these rigs.”48 Pressed on whether an independent Scotland should meet part of the decommissioning cost, Mr Ewing replied: “I think the point is if there is a rig that is still going to produce oil and gas for, say, 20, 25 years then perhaps some of that cost should be shared.”49 I find it inconceivable that a UK Government would accept that an independent Scotland could refuse to take on a substantial share of full decommissioning costs.

31. In my view, an independent Scotland would find itself in a severe state of indebtedness, with no insurance from fiscal transfer with the rest of the UK. Even in the event that a favourable settlement on future oil revenues was reached, Scotland would suffer from unstable fiscal balances because of an over dependency on North Sea oil. Such economic uncertainty would have implications for the wider UK.

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48 Energy and Climate Change Select Committee, Uncorrected transcript of oral evidence, (17 April 2012)
49 ibid.
Defence infrastructure and equipment

32. I draw the committee’s attention to written evidence submitted by Dr Michael Williams, Reader in International Relations at Royal Holloway, University of London, to the House of Commons Defence Select Committee in July 2012, as part of its inquiry into the potential defence implications of Scottish independence. I largely endorse Dr Williams’ position on how defence assets would be allocated.\(^{50}\)

33. The first major defence issue that would require agreement between an independent Scotland and UK Government is what to do with the Faslane Royal Navy base, home of Britain’s independent nuclear deterrent and soon-to-be home for the new nuclear Astute-class submarines. In the event that Scotland became independent, a Scottish Government would become operationally responsible for Faslane. However, as the SNP has stated its opposition to retaining nuclear weapons, this would precipitate immediate negotiations on the future of the fleet at Faslane. As a consequence of problems in re-locating naval assets at Faslane, a pre-condition of independence would be agreement on the UK’s long-term basing rights at Faslane. This might become a “red-line” issue for the UK – it would certainly push a very hard bargain, and Scotland’s ability to retain sterling as its currency or the Bank of England as a central bank, both preferences for the Scottish Government, might form part of any negotiating process.

34. As Dr Williams has pointed out, defence property inside Scotland would in all probability be transferred to an independent state, though this would have to be determined by an agreed formula based on Scotland’s financial contribution to UK defence – property and material, in excess of Scotland’s financial investment in defence, would necessitate an independent Scotland recompensing the rest of the UK.

35. Scotland’s separation from the UK would demand a division of military equipment between the two states. This would form part of wider negotiating process on division of assets and debt related to previous procurement of assets. Any other way of proceeding would be unacceptable. Dr Michaels rightly asserts: “It would be disingenuous of Mr. Alex Salmond and the SNP to believe that they should acquire weaponry, Land Rovers, helicopters, planes or ships (to name but a few pieces to be divided) without payment or assumption of debt related to such past procurement. It will thus be necessary to devise a formula for the transfer of equipment.”\(^{51}\)

36. Scottish independence would pose significant defence challenges for a new state. An independent Scotland would incur substantial start-up costs in developing a Scottish Defence Force, a Scottish Defence Department, procurement systems for kit, as well as intelligence agencies equivalent to GCHQ, MI5 and MI6. Scotland’s separation would result in defence problems for the rest of the UK, though these would be far less than for a newly independent Scottish state.

Gold reserves

37. Historically, when two nations secede from each other, assets have been split by geographic location or population proportionality. It is established international practice that assets should be divided in an equitable proportion. As the UN General Assembly

\(^{50}\) House of Commons Defence Select Committee, “Defence Implications of possible Scottish Independence – Written Evidence”, Dr. Michael John Williams, HC 483, (July 2012)

\(^{51}\) ibid.
International Law Commission states: “In the case of separation of part or parts of the territory of a State, movable State property as well as the State debt of the predecessor State shall pass to the successor State or States in an equitable proportion.”\textsuperscript{52} An equitable proportion should be agreed between the states. For example, the division of Czechoslovakian assets was agreed through a constitutional act. Most federal assets were divided on a ratio of 2 to 1, as this was the approximate ratio between the Czech and Slovak population within Czechoslovakia.

38. The division of assets, such as gold, would be inextricably linked to the division of debt. The whole package of assets and liabilities would need to be taken into account. As a result, it would not be possible to precisely predict how individual assets such as gold would be divided until wider decisions about liabilities were agreed. It may be that while the overall package of assets and liabilities would be divided on one criterion, certain assets within that package could be divided differently.

39. International precedence suggests that the division of UK gold reserves would not be a simple task. In the break-up of Czechoslovakia, for example, disagreements about dividing the debt meant that there was a stalemate in the division of gold. The division and handover of gold reserves was a major area of conflict in Czech-Slovak relations. This was because of disagreements over dividing the balance sheet (in particular, debt) and as a result the Czech National Bank withheld Slovakia’s gold reserves. This was only resolved seven years after separation through the signing of the treaty on the joint procedure in dividing assets in November 1999. It was not until 2000 that the Czech National Bank handed over the remaining part of the gold from the reserves of the former State Bank of Czechoslovakia to the National Bank of Slovakia.

40. It is unclear what would happen to the UK’s gold reserves in the event of Scottish independence. The major complicating factor is the Scottish Government’s commitment to keep sterling and preference for the Bank of England to remain as Scotland’s central bank. As the Scottish Government propose to retain sterling and not establish an independent central bank, it does not seem unreasonable to suppose that HM Treasury would insist that the UK Government retain all gold reserves.

Currency, monetary policy and financial regulation

Currency

41. There are, as I see it, essentially three basic currency options available to an independent Scotland: one is to join the euro; one is to retain sterling; and the other is to create an independent Scottish currency.

42. The preferred position of the Scottish Government is now to retain sterling. There would be two options for an independent Scotland wishing to keep the pound.

43. Firstly, Scotland could adopt what Professor John Kay – a former member of Mr Salmond’s Council of Economic Advisors – described, in his evidence to your committee, as the “Montenegrin solution.”\textsuperscript{53} Montenegro is not a member of the Eurozone – or, in fact, the EU – but uses the euro as its currency. Kosovo also uses the


\textsuperscript{53} House of Lords Economic Affairs Committee, Uncorrected transcript of oral evidence, (22 May 2012)
euro in a similar way. This is, however, not unique to the Balkan Peninsula: Andorra, Monaco and San Marino also use the euro, despite not being members of the Eurozone. In a similar way, the US dollar passes for legal tender in Ecuador, El Salvador and Panama.

44. Unilaterally adopting sterling – what economists’ term “sterlingisation” – would allow an independent Scotland to keep the pound without having to negotiate with Westminster. But, if Scotland pursued such a course, the Bank of England would be under no obligation to act as a “lender of last resort” for Scottish financial institutions.

45. Moreover, as is currently the case, current or savings accounts and cash ISAs are guaranteed up to £85,000 per person in case of a bank failing. The bank guarantees currently only protect the funds of customers who are based in the country in which the bank is based. Without a “lender of last resort”, Scottish banks might become inclined to move to England.

46. It is uncertain that the UK would agree to the Scottish Government’s preferred option of the Bank of England becoming its central bank. If this did not occur, a separate Scotland would have no “lender of last resort” and would be wholly unable to bail out its banks should another a financial crisis arise.

47. Secondly, an independent Scotland could enter negotiations with the UK Government to form part of a sterling monetary union. The first and most obvious point relating to this scenario is that such an agreement would be subject to the consent of the UK Government. The Scottish Government should not take this for granted: I do not think it should simply be assumed.

48. I am not aware of a comparable instance in history of a political union being dissolved and accompanied by maintenance of an existing monetary union. Successful monetary unions – such as the United States monetary union forged in the aftermath of the Civil War or the German Customs Union created in the nineteenth century – were preceded by political union. Both formed part of a nation-building enterprise, while what the Scottish Government proposes is breaking up an existing nation state. Equally, other attempts at currency union – such as the Latin American Monetary Union, Scandinavian Monetary Union and East African Currency Area – do not fit the model proposed by the Scottish Government.

49. The closest comparison I can think of is the Belgium-Luxembourg Economic Union that existed from 1921 to 1999. But the likeness is not exact. The respective countries maintained separate currencies, while only the Belgian franc served as legal tender in both nations. Despite the maintenance of formal joint agencies, Luxembourg essentially existed as an attachment to the Belgian monetary system. The monetary policy of both countries was decided by the Belgian Central Bank. If Scotland became independent, and agreement was reached on the continued use of sterling, I believe something approximate would happen with the Bank of England. Scotland’s monetary policy would be set by an authority largely concerned with economic conditions in the rest of the UK – as Belgian interest rate decisions were informed by economic conditions in Belgium, rather than Luxembourg. The Treasury, moreover, has stated in the most explicit terms that adopting sterling would not give Scotland any leverage over interest rates.54

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54 Simon Johnson, “Treasury: Independent Scotland would have no control over interest rates”, Daily Telegraph, (1 June 2012)
Johann Lamont—Written evidence

The cost of borrowing or taking out a mortgage in Scotland, as a consequence, would be decided by a foreign country.

50. The two other options available to an independent Scotland, which are not the preferred options of the Scottish Government, are to create a Scottish currency or join the euro. It is perhaps confusing that these are the two options previously favoured by the SNP.

51. In 1989, for example, Alex Salmond told the House of Commons: “A Scottish pound within the European monetary system would allow for a monetary policy suitable for Scottish domestic requirements against a framework of European currency stability.”

Then, as the single currency started to emerge as a reality, the SNP adopted a policy stance in favour of an independent Scotland joining the euro. In November 1999, Mr Salmond told MSPs: “The argument for being in the euro is that it will get us out of the position in which a capital denominated over-valued currency is doing severe damage to the Scottish economy.”

The SNP's position in favour of the euro remained until quite recently. In late 2009, for example, Alex Salmond told Spanish TV that there were strong arguments for joining the euro: “I think the argument for having strong fiscal powers, powers over revenue, powers to expand the economy within a monetary context, within a European euro context, will prove to be a very strong one for the people of Scotland.”

The SNP abandonment of joining the euro, in my view, has coincided with the Eurozone crisis, making it politically difficult to argue for membership of the single currency.

52. As regards the viability of an independent Scottish currency, I am in agreement with the comment, contained in written evidence to your committee submitted by Professor Iain MacLean, that this is not a “realistic option.”

I also agree that the likely impact of establishing a Scottish currency would be a likely depreciation against sterling in the first days and weeks.

53. As has been pointed out to the committee, analysis by Business for New Europe on the EU Treaty legalities around an independent Scotland remaining “in” or “out” of the EU are such that a Scottish Government would have to commit, at least in principle, to joining the euro. This raises questions about what mechanism would be put in place to assess membership. The previous Labour Government, in October 1997, outlined five economic tests that would need to be met in order to recommend euro membership. Would an independent Scotland adopt similar assessment criteria for recommending membership? If not, what would be the assessment criteria? In the event of independence, would the assessment criteria for euro membership have to be agreed with the Treasury as a precondition of an independent Scotland joining sterling?

Monetary policy

54. The monetary policy framework established by the last Labour Government was arguably its greatest success. The MPC works according to a mandate set by the Treasury and Westminster. The Governor of the Bank of England, Sir Mervyn King,
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summarised this point very clearly in his BBC Today Programme Lecture. He said: “Our job is given to us by the Government and by Parliament.”

55. The Treasury retains substantial powers under the Bank of England Act. The Act gives the Chancellor of the Exchequer sole power in setting the remit to which the MPC must work. The objectives of the MPC are currently twofold. These are: (i) maintenance of price stability; and (ii) subject to the maintenance of price stability, support of the Government’s economic policy, in respect to growth and employment. The monetary policy remit is specified at least once every 12 months in a letter from the Chancellor to the Governor of the Bank.

56. An independent Scotland would have no role in defining the objectives to which the MPC must work. A Scottish Finance Minister would play no part in defining price stability or the economic objectives that MPC decisions must support. This would remain the Chancellor of the Exchequer’s responsibility.

57. An independent Scotland would also have no role in defining what price stability is taken to consist of. The Bank of England Act gives the Chancellor complete discretion in this area. It is only the Chancellor who has the powers to adjust the inflation target either upwards or downwards, change the measure of inflation, or even adopt a different inflation regime. This is not a dry academic matter. For the first six years of the MPC, price stability was defined as an inflation rate of 2.5 per cent based on the RPIX measure of inflation. In 2003, the inflation target was changed to 2 per cent, based on the CPI measure. The move from RPIX to CPI and change in the inflation target would not have required any consultation with an independent Scotland.

58. Then there is the question of Scottish representation on the MPC. The MPC currently has nine members. To be more precise, the Bank of England Act stipulates that the MPC must consist of the Governor of the Bank, who chairs proceedings; two Deputy Governors; four “external” members appointed by the Chancellor; and two Bank officials selected by the Governor after consultation with the Chancellor. In addition, a “non-voting” Treasury Representative also sits on the MPC.

59. The Scottish Government appear to believe that changing the composition of the MPC will be an easy matter. First of all, Nicola Sturgeon, the Cabinet Secretary for Infrastructure and Investment, claimed on a BBC TV programme in May that, although there was no Scottish representation on the MPC at the moment, this was “something that would change if Scotland was independent.” She claimed a Scottish Finance Secretary “could appoint somebody” to the MPC. This is not my understanding of the Bank of England Act. The MPC’s composition can only be altered by amending existing legislation. This would be subject to the will of Westminster.

60. Then, at First Minister’s Questions on 31 May, following questioning on the subject by myself, Alex Salmond said: “We [meaning an independent Scotland] expect to be a part of the appointments process.” He also set out his expectation that an independent Scotland would “have the same representation” as the Treasury non-voting observer. Mr Salmond’s claim that an independent Scotland would “expect to be part of the appointment process” suggests that he at least understands a Scottish Finance Minister

would have no formal powers of appointment. My view is that it would be wholly at the Treasury’s discretion to decide on whether to consult on this matter.

61. Putting aside the fact that securing Scottish membership on the MPC would require the jumping of a very big legislative hurdle, the Scottish Government have not stipulated whether:

- A Scottish representative would be a voting member or non-voting representative – or, indeed, whether they expect to have both, as Mr Salmond’s statement in May seems to imply.
- If there is a Scottish voting member, whether this would be an “external” or “internal” appointment.
- If it is to be an “external” member, whether this is to be an additional member to the current four.
- If the Scottish representative is to be an additional member, how this would affect the delicate nine-member composition of the MPC, which ensures that the Governor always has a casting vote.
- Or, finally, whether the Scottish MPC member would be held to account by the Treasury Select Committee or the Holyrood Finance Committee? Indeed, would all members of the MPC be subject to scrutiny by Holyrood, given that they would all make decisions effecting two independent states?

62. Moreover, all of this neglects one important point, namely that the MPC was deliberately set up as an “expert” committee, not one that represents geographical interests. This should, in my view, remain the case.

63. Finally, it is not clear that the Scottish Government fully grasps that the Chancellor retains legislative powers that enables interest rate decisions to be taken back into the Treasury. Under the Bank of England Act, the Treasury can “give the Bank directions with respect to monetary policy” if it is “satisfied that the directions are required in the public interest and by extreme economic circumstances.” In such circumstances, a Chancellor would act in the interest of the rest of the UK – not Scotland.

64. It is also within the Chancellor’s powers to “rip up” the Bank of England Act and set interest rates – as was the case prior to 1997. If a Government were elected that was unconvinced of the merits of the current monetary policy framework, responsibility for interest rates could be annexed by the Treasury. I do not envisage this happening: I only point out that a situation could emerge where a Chancellor would revert to pre-1997 monetary policy arrangements.

65. Finally, the idea that the MPC would raise interest rates to counter inflationary pressures in an independent Scotland, if this were not in the economic interests of England, Wales and Northern Ireland, is absurd. When making interest rate decisions, the Bank of England would, in all likelihood, pay as much attention to conditions in Scotland as the ECB does in Montenegro or the US Federal Reserve does in Panama.

Financial regulation

66. The position of the Scottish Government on what would happen to financial regulation in the event of independence is unclear. In a June 2009 interview, John Swinney said that he wanted regulation of Scottish financial services to be devolved to Scotland. He said: “I quite clearly want the Scottish Government to have the full range of responsibilities [over financial services].” From this statement, not unreasonably I hope, I drew the conclusion that the Scottish Government wanted an independent Scotland to have responsibility for financial regulation. However, in February 2010, when giving evidence to the Scottish Parliament’s banking inquiry, my predecessor but one, Wendy Alexander, pressed him on whether he continued to believe that Scotland should have a separate financial regulatory authority while remaining part of the UK. He responded by saying there was an ongoing debate about where the appropriate level of regulation should lie, whether at a Scottish level, a UK, European or global level. In June 2012, Mr Swinney changed his position again. Addressing a business audience in Glasgow, he said the Bank of England would take on the role of regulator for Scottish financial services in the event of independence.

67. I agree with Scottish Financial Enterprise – the body which represents Scotland’s banks, insurance companies and pension providers – that the Scottish Government’s current proposals for regulating the industry in an independent Scotland appear to contravene EU law. Owen Kelly, the Chief Executive of Scottish Financial Enterprise, said an independent Scotland would need to create a separate financial regulatory authority. If this were to happen, cross-Border companies would have to spend millions complying with two sets of red tape. Leaving aside the legality of what is being proposed, Sir Howard Davies, a former Deputy Governor of the Bank of England and the FSA’s first chairman, has rightly pointed out that a UK financial industry regulator could not serve two independent Governments.

68. I have been taking a keen interest in how the Financial Services Bill, currently before Parliament, would be affected by Scottish independence. The Bill, which will transfer oversight and regulation for the stability of the financial sector to the Bank of England, will establish three new bodies:

- The Financial Services Committee, as a committee of the Court of the Bank of England, to oversee macro-prudential regulation of the financial system;

- The Prudential Regulation Authority, as a subsidiary of the Bank of England, which will have responsibility for micro-prudential regulation of financial institutions that manage significant risks on their balance sheets; and

- The Financial Conduct Authority to supervise all firms to ensure market integrity, consumer protection and effective competition in a way that advances the interests of all users and participants.

69. Given that the Bill’s aim is to ensure the stability of the UK financial system, an independent Scotland using sterling would have to adhere to its provisions of the Bill. It is inconceivable that the UK Government would relinquish any control of responsibility

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63 James Hall, “John Swinney blames tripartite system for fall of HBOS”, Daily Telegraph, (15 June 2009)
65 Ibid.
Johann Lamont—Written evidence

for financial stability for so long as a common currency existed. The alternative policy of unilaterally adopting sterling would mean not only losing the Bank of England’s protection of “lender of last resort”, but would require the creation of a separate system of regulation.

70. To the extent that any future Scottish Parliament chooses to set up a separate regulator, it would have to consider a number of matters, including:

- Would the regulator(s) be responsible for the functions of both the PRA and the FCA?

- Would it adopt all existing UK financial services rules and regulations at the outset or would it set out to make its own rules?

- How might any new rules impact on the competitiveness of Scottish business?

71. If the regulations on both sides of the border were not identical, A Scottish bank with branches in both Scotland and England might well have to operate two different sets of documentation and procedures. This would inevitably push up costs for business. Similarly, an English or international bank operating in Scotland could be required to develop separate forms and procedures. Having to follow a different regulatory regime may act as a possible disincentive to opening branches in Scotland. This is a particular risk where a bank has only a small number of branches and the cost of running a separate regime might be disproportionate.

Fiscal policy and taxation

72. The Scottish Government’s position on how fiscal policy would operate under independence has been confused. For example, when pressed on the economics of independence, during an interview with Andrew Neill in March 2012, Alex Salmond said that a prerequisite for a functioning “sterling area” would be a “fiscal stability pact” between Scotland and the rest of the UK. However, six months later, when addressing an audience in the US, Mr Salmond said there was no need for a “fiscal stabilisation pact.” In response to a question at the Chicago Council on Global Affairs, relating to potential fiscal restrictions flowing from monetary union, he said: “I don't believe that a monetary policy restriction would have to have a fiscal stabilisation pact. I think we can have plenty of room for manoeuvre within a currency union.”

73. My own reading of history is that successful monetary unions require fiscal rectitude imposed by a central finance ministry.

74. Let me use the examples of the Eurozone and United States to illustrate my case. The current difficulties facing the Eurozone derive from the fact that it is a monetary union without a corresponding fiscal union – or, at least, an effective governing authority to impose fiscal discipline on member states. This is why the German Chancellor, Angela Merkel, has been urging a move towards a European fiscal union with powers of enforcement.

75. The aim of the Stability and Growth Pact was to ensure that countries adopting the euro would not:

- Run an annual budget deficit of higher than 3 per cent of GDP; and
- Allow national debt to be more than 60 per cent of GDP.

76. When the move towards monetary union was underway, Germany wished to ensure that the ECB followed the model of the Bundesbank. After all, the Bundesbank, with its legal obligation to pursue price stability as a primary objective, provided the foundation on which the post-war German economic miracle was built. With its understandable fear of inflation, Germany was concerned that the ECB’s anti-inflationary policy might be undermined by other Governments pursuing irresponsible tax and spend policies. Unfortunately, even with an agreed pact, this is what happened. The Stability and Growth Pact has proved an inadequate mechanism for imposing fiscal discipline.

77. Rules without enforcement do not work. More importantly, experience suggests that big countries have a tendency to ignore the “rules of the game”, and pursue their own economic interests when circumstances demand. In the autumn of 2003, for example, France and Germany worked to block implementation of the Stability and Growth Pact by rejecting a Commission recommendation to move in the direction of sanctions. France and Germany were able to avoid punishment because of the large number of votes they command on the Council of Ministers, which must approve sanctions.

78. The United States, in contrast, is an example of a successful monetary union. The success of the US is based on the fact that the benefit of the dollar to federal states outweighs the potential economic gain to them of not being part of the monetary union. Levels of political pain are small and temporary enough to be politically tolerable. As a consequence, increased unemployment or falling growth in New York or California does not lead to calls from the Governor’s Mansion in Albany or Sacramento for these states to break from the dollar and form independent currencies in pursuit of economic competitiveness.

79. This is made possible by two main factors: (i) a high degree of political and social cohesion in the US; and (ii) a common federal fiscal policy. These two conditions were absent in the Eurozone. The first of the two – political and social cohesion – would not be as absent between Scotland and England, as, say, with Germany and Greece. Although, it is worth noting that the SNP’s express objective – its very reason for being – is to dismantle the political cohesion of the UK. The second of the two factors would not exist under the SNP’s plans for independence.

80. The SNP’s proposals will not lead to fiscal independence. As Professor David Bell and Professor Bob Elliott – two of Scotland’s leading academic economists – argued in a recent report for the David Hume Institute: “it is realistic to assume that monetary union would also entail co-ordination, if not integration, of fiscal policy. Therefore, an independent Scotland would have no command over one major instrument of macroeconomic policy, monetary policy, and limited control over another, fiscal policy.”

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81. As I have indicated, what the SNP are proposing amounts to an Anglo-Scottish version of the European Stability and Growth Pact. It is my firm belief that this would be disadvantageous to Scotland. Assuming that the Chancellor agreed to enter a “fiscal stability pact”, it is likely that the Treasury would insist on enforcement mechanisms much stronger than the European Stability and Growth Pact.

82. At the very minimum, it would be necessary to establish a robust institutional framework to ensure that agreed rules were enforced. The UK Government would hold the upper hand in determining such a framework. Even if this was overcome, and an overarching authority to ensure application of the rules was established, experience suggests that ensuring enforcement is a completely different matter.

83. The Scottish Government, therefore, must answer the following questions:

- Will their proposed “fiscal stability pact” be similar to that adopted for the Eurozone? In other words, will there be an independent authority to monitor observance of the rules and a multi-national committee to impose sanctions?

- If so, what would this look like? Who would sit on the independent authority? Politicians? Economists? Technocrats? And, furthermore, what would be the balance of representation between Scotland and the rest of the UK?

- Do the Scottish Government accept that Scotland would play the junior role in the establishment and operation of such an institutional framework? If so, how will this be to Scotland’s advantage?

- If the rest of the UK broke the fiscal pact, how would an independent Scotland ensure enforcement of sanctions? What would stop the UK Treasury from breaking the rules and pursuing their own perceived interests as France and Germany have done?

84. Mr Salmond’s idea of a “sterling area” might potentially work if a large measure of sovereignty over macro-fiscal objectives was transferred to a supranational UK authority with powers to enforce sanctions. Personally, however, I do not believe this would be enough. Successful monetary unions, as history has shown, require common fiscal policies. I think it would eventually become necessary to establish a finance ministry to coordinate fiscal policy with the Bank of England’s monetary policy.

85. In a sense we already have such a body in the shape of the UK Treasury. The long and the short of it is that an independent Scotland, if it adopted sterling, would be subject to a large measure of oversight by the Treasury on fiscal policy, taxation, borrowing and spending.

October 2012
Transcript to be found under Ruth Davidson MSP, Patrick Harvie MSP, Johann Lamont MSP and Willie Rennie MSP—Oral evidence (QQ 587-600)
Sir Nicholas Macpherson, Permanent Secretary to the Treasury and Rt Hon Danny Alexander MP, Chief Secretary to the Treasury—Oral evidence (QQ 500-525)
TUESDAY 29 MAY 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Currie of Marylebone
Lord Forsyth of Drumlean
Lord Hollick
Baroness Kingsmill
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witness
Professor Gavin McCrone

Q117 The Chairman: Welcome, Professor McCrone, to the Economic Affairs Committee. This is the third public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. When I saw you being suggested as a witness, I seemed to recall, from my dim and distant past, that I had read a book of yours. I found it on my bookshelves this weekend. It was Scotland's Economic Progress 1951-1960.

Professor McCrone: Gosh, that is a long time ago.

The Chairman: It was sent to me for review.

Professor McCrone: Good Lord.

The Chairman: But I never did review it because I think I had changed career by the time it had reached me. Anyway, the subtitle was A Story in Regional Accounting, and if you substitute “National” for “Regional”, I think we might actually be covering some of the ground we hope to cover today. But since then you have had a very distinguished career in
academic and public service occupations, and I think you are an admirable witness to also set the scene for us.

I know that you have been publishing a series of articles, which we have all seen, in The Scotsman recently on this issue. The title of the one that you published in February was “Greek Lessons for a Scottish Government”.

Professor McCrone: Yes.

The Chairman: I note that you concluded, after covering some of the issues, “There is a lot to be considered and explained before we vote in the referendum”. That is exactly the position that this Committee took when we decided to undertake this inquiry, because we feel that there is a great deal that has not been properly explored right across the economic front. We are not interested in the constitutional implications, and we are certainly not taking sides on the issue of the referendum, but on the economic front we feel, both for Scotland and for the rest of the United Kingdom, there are so many issues that we wish to explore and we hope to cover some of them with you today.

Would you like to make a statement or shall we go straight into questions?

Professor McCrone: I think go straight into questions. The only thing I would say is that although that article was entitled “Greek Lessons for a Scottish Government”, The Scotsman always choose their own titles, so that was not the one it was published under.

Q118 The Chairman: Which is a pity, because it was a provocative title. Could I then start by asking a question? If Scotland becomes independent from the rest of the UK—and we are talking about that at this stage and not devo max—some of the UK’s stocks of assets and liabilities would have to be divided. Which assets and liabilities would you feel are the most important to consider from an economic perspective, both for Scotland and the rest of the United Kingdom, and what would be your guiding principles in making such a division?

Professor McCrone: I think the most obvious ones are North Sea oil and the national debt. There are also the defence installations—that is a minefield, I think—and there are public pensions and a variety of other things, but North Sea oil and the national debt are the two big ones. The Scottish Government take the view that the North Sea oil would be divided according to what geographical area it was in, and on that basis Scotland would have about 90% of the North Sea oil. There would be a dividing line that would go up roughly north-east from Berwick-upon-Tweed, not a line of latitude but north-east, roughly. That would put some of the oilfields in the English territory, but the bulk of them would be in the Scottish territory. I may say, actually, the bulk of them are in Shetland territory.

As for the other things, the national debt I would have thought would have to be split on the basis of GDP. It could be done on a population basis, but it would not make much difference because Scotland’s GDP per head is now approximately the national UK average—just under the UK average. So if you apportioned it that way that would probably be the most sensible way. However, the Scottish GDP goes up by about 20% if you put North Sea oil into it.

Q119 The Chairman: Just briefly on the question of the Shetlands, which you mentioned, do you have any view about how that should be included?

Professor McCrone: It was rather interesting that Tavish Scott, in a column in The Scotsman about a month ago, said that Shetland and Orkney were in a very good bargaining position, which I think is quite true. I know Shetland very well, and the Shetlanders only regard themselves partially as Scots, really, and who knows what might happen there. I always think that the status of Faroe in relation to Denmark is something that could be of interest to
Shetland. The Faroe Islands are a dependency of Denmark rather than an integral part of Denmark, which means they are not in the European Union but can trade freely in the European Union, and they get a lot of advantage from that because of their fishing industry.

Q120  The Chairman: On public pension assets and liabilities, how do you feel that should be dealt with?

Professor McCrone: I do not really know, but a lot of the public pensions, of course, are not funded; they are simply paid out of revenue. So I suppose that that would be the practice that would be adopted, for instance, for civil service pensions. I do not know what would happen with teachers, but it would be a very difficult split for the ones that are actually funded, I suppose. As for defence, I think that is a nightmare.

The Chairman: Yes. We will obviously be taking other evidence on defence.

Professor McCrone: Yes.

Q121  The Chairman: Are there any important items that you think should not be divided?

Professor McCrone: I do not really think so. If Scotland becomes independent, then a lot of consequences follow from that, and it then becomes much more difficult to see various things being shared. Things like foreign embassies and so on, I suppose, might be at least partially shared, but I do not see any financial flow being shared.

Q122  Lord Lawson of Blaby: On the last point, it is very difficult to see how you could share a foreign embassy if the two countries had different foreign policies, which might be the case.

Professor McCrone: It might easily be the case. But on the other hand, it is quite common for the embassy of one country to act on behalf of another one, so I suppose that is how it would be done.

Q123  Lord Lawson of Blaby: I want to come back to the Shetlands, because you drew our attention, very properly, to the importance of that. Presumably the Shetland islanders would effectively have a choice as to whether they wished to remain part of the United Kingdom or wished to be part of an independent Scotland. As you said, they would have a very strong bargaining position because they would see which of those two courses would give them a more attractive deal all round. Have you any inkling—because you say you know the Shetland Islands well—of which way that might go, and indeed how long this process would take? It seems to me that even if the Scots do vote for independence, there are a lot of important issues that are going to have to be decided, where there is no clear international law that governs how they are decided. They have to be decided by negotiation, and this negotiation and discussion could take a very long time, could it not?

Professor McCrone: Yes, indeed, it certainly could, and there are a lot of things to be sorted out. As for Shetland, incidentally the Shetlanders call it Shetland not “the Shetlands”. They are quite sensitive about that point.

Lord Lawson of Blaby: I understand sometimes they call it Zetland.

Professor McCrone: That is in the past, yes. I have no inkling what would happen. It has never been suggested to me from any of my contacts in Shetland that they would want to stay with the United Kingdom if Scotland became independent. It is just that I was interested
that Tavish Scott raised this issue of trying to get a good deal for them. Incidentally, they have quite a good deal already because, unlike Scotland, they actually have an oil fund.

**Lord Lawson of Blaby:** Well, it makes sense in their case, yes.

**Professor McCrone:** Yes.

**Q124** The Chairman: If the outcome was devo max rather than Scottish independence, what differences do you think there would be in terms of the split of assets and liabilities compared with independence?

**Professor McCrone:** I do not think anyone quite knows what devo max is. It is usually put forward in the terms that Scotland would raise all its own tax revenue and be responsible for all its own expenditure, and I do not think that is really possible within one nation state. I think it raises horrendous difficulties. But if Scotland remained part of the United Kingdom on whatever basis, then how assets like North Sea oil were divided would be a matter of negotiation, I would have thought. It would not necessarily follow the same course as it would if Scotland was independent. The same with the national debt: I do not know how we can deal with the national debt in that sort of situation.

**Q125** Lord Lawson of Blaby: With devo max—we are involved not in the political side of things but in the economic, but I agree with you that it is very uncertain what devo max means and whether it makes sense—it would presumably mean that Scottish representation in the House of Commons would be reduced, if not to zero, to something like two, would it not?

**Professor McCrone:** I do not know.

**The Chairman:** Anyhow, that is a constitutional issue and not one that affects us in this Committee.

**Professor McCrone:** It is, but all these things would have to be negotiated. When Northern Ireland got home rule in 1922, its representation in Westminster was reduced substantially. The Scottish representation in Westminster was reduced about half a dozen years ago, when I was on the Boundary Commission, because it was regarded as over-represented. The revision was to take it down to constituencies with the same number of constituents, on average, as the English ones. If it were devo max, whether it would go down further or not, I think that is a matter that would have to be negotiated.

**Q126** Lord Lawson of Blaby: Going back to the economic front, which is the purpose of this inquiry, is it clear-cut how public expenditure flows would be divided between an independent Scotland and the rest of the United Kingdom? Presumably all the existing arrangements, including the Barnett formula, would go by the board, would they not?

**Professor McCrone:** Yes.

**Q127** Lord Lawson of Blaby: So this is not really a difficult issue; it might have profound consequences, but it is not a difficult issue.

**Professor McCrone:** I do not think so. Scotland would just be entirely dependent for funding its own public expenditure. Barnett would have gone.

**Q128** Lord Lawson of Blaby: There is one specific aspect of the public expenditure equation, which might be a little bit more complex. In your very interesting paper, “Independence and devo max: the unanswered questions”, you state: “Scotland could not
expect to get part of the UK budget rebate that Mrs Thatcher negotiated at Fontainebleau”. That is assuming that Scotland remains within the European Union, which is—as with on what terms and so on—again unclear, and Scotland would have to pick up the common agricultural policy. This would be quite substantial numbers in terms of the size of the Scottish economy, would it not?

Professor McCrone: Yes. I think, for two reasons, it would not get a share in the rebate. One is because the other European countries would not want it to because they would like to end it anyway and, second, because I do not think that Scotland’s economic situation would justify it in the same way as the UK’s did at the time it was negotiated. Scotland receives quite a lot of money already through the structural funds and things of that kind—it has a different sort of agriculture from the UK average and so on—so I do not think the issues that arose in relation to the UK would be so strong in connection with Scotland. I have not examined this in detail, but that is my impression.

As you say, it is very difficult to know what the position in the EU would be. There are constitutional experts, like Sir Neil MacCormick, who say it would remain in the EU, but there are others who say, “Well, it might not”. It intends to remain in the EU, as far as I understand the Scottish Government’s position, but, goodness knows, there would have to be a negotiation, and part of that negotiation would no doubt cover whether or not there was any rebate available to Scotland, and I would counsel that there would not be.

Q129 Lord Lawson of Blaby: That is very clear, and we can base ourselves on that answer. On the main issue of whether Scotland should, even if it wished to, be a member of the European Union, that is not a matter for professors of jurisprudence or European law to pronounce on but is, as you say, a matter for negotiation. It would have to be unanimously agreed and every member country would have a veto on it, including the United Kingdom—although we certainly, as a good neighbour, would not wish to cast a veto, there might be other countries that were not happy with the idea.

Professor McCrone: Yes. There is no precedent as far as I know. There is no bit of the European Union that has been in this situation. I suppose all member states would have to agree. But the point really is that Scotland is a member of the European Union at the moment, so that if the answer was no it would have to be kicked out, I suppose. So I really do not know how that would work.

Q130 Lord Lawson of Blaby: With respect, I do not think Scotland is a member of the European Union.

Professor McCrone: Well, it is as part of the UK.

Lord Lawson of Blaby: It is the United Kingdom that is a member of the European Union.

Professor McCrone: Yes, exactly.

Lord Lawson of Blaby: An independent Scotland is a new ball game, and it would require an amendment to the treaty, which requires unanimity.

Q131 Lord Tugendhat: I declare, I suppose, some sort of an interest in that I was the European Community’s—as it then was—Budget Commissioner at the time that the rebate was negotiated. Putting aside the politics of that, obviously the underlying justification was that the European budget was very badly skewed to the disadvantage of the United Kingdom because of the scale of agriculture and the regional fund and so forth. In the event of Scotland leaving the United Kingdom, the rest of the UK would be disadvantaged more than
it is at present on the flow of EU funds. This is something one would have to look into, but I suspect it would be disadvantaged more than it is at present and Scotland less than at present, because Scotland is a beneficiary of the regional fund and of all kind of agricultural subsidies for the Highlands and Islands and so forth. So, while Lord Lawson is, of course, right that this would have to be part of the negotiation of Scotland's entry or re-entry into the European Union, in which Britain would play a part and others would play a part, the underlying justification of the rebate would be different in the case of Scotland than it is in the case of the rest of the United Kingdom.

Professor McCrone: Yes, exactly. I think that is why I said what I did in that article. Scotland has a very large part of the less favoured area under the agricultural policy. Much of that could not exist without the single farm payment, and its position is therefore quite different from the south of England, for instance.

Lord Tugendhat: Absolutely.

Professor McCrone: I do not know about the north of England. I chaired the committee of inquiry into the future of Scotland's hills and islands for the Royal Society of Edinburgh, and we were rather dismayed at the line that successive Government Ministers took that they wanted to end direct payments to agriculture from the common agricultural policy and just have structural measures and so on. On that basis, a huge part of the Scottish agriculture would just collapse, even in the Orkney Islands, which are quite fertile.

Q132 Lord Tugendhat: Could I ask one other question, on a quite different issue? You were talking about Barnett formula transfers and defence spending. As I understand it the SNP is quite divided on the subject of defence. Some of them would like to stay in NATO and some of them would like to leave NATO. Presumably that dispute or that debate has profound economic implications, because were Scotland not to be a member of NATO, then it is hardly conceivable that the United Kingdom could have defence installations in Scotland, whereas if Scotland were to become part of NATO, then clearly it would be much less difficult to have significant defence installations in Scotland.

Professor McCrone: Yes, I think that is right. Of course, the particular bone of contention is the nuclear facility in the Clyde, which Alex Salmond has repeatedly said would not be there if Scotland was independent. I think that would be a very difficult issue to deal with. I am no expert in defence, but one of the questions is: where the devil does it go if it is not in the Clyde? It would be very expensive to shift it, I would have thought. So there is all that, but then there is also the question of whether naval equipment would be bought from Clyde shipyards and things of that kind, which—

Lord Tugendhat: And RAF Leuchars.

Professor McCrone: Yes, exactly.

Q133 Lord Lipsey: The Scottish Government has opted for at least three quite expensive programmes of public expenditure that do not exist south of the border, namely free personal care, free tuition and prescription charges. Are these material and how would they be funded by an independent Scotland?

Professor McCrone: They would just have to be funded by using money that otherwise might have gone for something else. So it would come off some other bit of the Government's budget, as indeed it really has to do at the moment because they do not get any extra money for doing these things, but it means they have to find the money from somewhere else. The free tuition fees, I think, are a particular problem. Of course, if
Scotland became independent, that issue would get much worse, because England would then be a separate country under the EU and its students would not have to pay tuition fees.

Lord Lipsey: Yes.

Q134 Lord Levene of Portsoken: Could I just ask you a question? I apologise for speaking from a position of total ignorance, but you were talking about the Shetlands and their potential holding of part of the oil reserves. Does the population of the Shetlands stand in the same sort of ratio to Scotland as in other areas? In other words, if they got the oil reserve, would a very small part of the population have a huge bonanza and end up like a sort of mini-Qatar?

Professor McCrone: There are 21,000 people in Shetland so, yes, they would do rather well. They have done quite well already. Thanks to the foresight of the Council of the time, led by its chief executive Ian Clark, they negotiated a very tough deal with the oil companies whereby they got a substantial amount of revenue into their oil fund—it is now called a charitable fund, but it was originally called the reserve fund. That amounts to a considerable sum, and it has resulted in them being able to spend money on facilities for the elderly and all sorts of things in Shetland. If you go to Shetland, you find the facilities for all these things—libraries, care for the elderly in the community and so on—are excellent, far better than anywhere else in Scotland, but most people do not go there, so they do not know.

Q135 Lord Lawson of Blaby: You have done a lot of writing and thinking about this issue—the economic issue. Of course, this question is not purely an economic issue, but on the economic front is it your conclusion that the threat of Scottish independence might be economically better for Scotland than the actuality, should it occur?

Professor McCrone: I do not think I quite follow why that might be so.

Lord Lawson of Blaby: Because they might be able to negotiate a deal.

Professor McCrone: Oh, I see. A better deal?

Lord Lawson of Blaby: A better deal.

Professor McCrone: I suppose that would depend on how the Government in Westminster would react to the situation. I suppose what might happen—this is pure speculation—is that with the Scotland Act that has presently gone through with the Calman proposals, more devolution might be put in order to try to satisfy the—

Lord Lawson of Blaby: Yes, devo max.

Professor McCrone: Nearer devo max. Personally, I do not think devo max would work if they were still within the United Kingdom, but more devo. We could discuss maybe what those might be, but it is a bit difficult to know because it is pure speculation.

Q136 Lord Forsyth of Drumlean: It would be very helpful if you would elaborate on why you think that devo max would not work, what you think might work and why you think it would work.

Professor McCrone: Devo max means that they would have power to alter any tax. They still could not alter VAT, actually, because under the European Union treaties you cannot have different rates of VAT in one country. You could alter income tax and corporation tax, National Insurance contributions and most of the other taxes, but not VAT. I know a lot of people do not agree with me about this, but I think there would be great difficulties if there
were big differences in corporation tax, for example. It has been suggested that what Scotland needs to do is to cut its corporation tax in the way that Ireland did. Well, Ireland got away with it, but I think if Scotland was to try to do that, there would be tremendous problems in the north of England, which would regard this as totally unfair. The Treasury would be bound, therefore, to do something about it, to match it or something, or to veto Scotland doing it or something of that kind. So there would be great problems about that.

I think there would be considerable problems if you had different rates of National Insurance contributions and different welfare benefits. Already people are a bit fussed about the things that we have mentioned, the care for the elderly and so on. There was a television programme in Scotland a year or so ago in which some inhabitants of Berwick-upon-Tweed were being asked if they wanted to become part of Scotland again, and they were saying, “Yes, if we get free care for the elderly, that would be splendid”. That is the kind of basis on which people decide these things.

I think there would be tremendous friction. That is why I just do not think it would be practical. Then there is the question of whether you retain the same currency and whether Scotland would be allowed to budget for a deficit and destabilise the currency, and all that kind of thing. So there are a lot of problems in it. That is why I am very doubtful that it would work.

The Chairman: Lord Shipley, do you want to come in at that point?

**Q137 Lord Shipley:** I want to ask you about what needs to be clear before a referendum takes place and what can be left safely to some kind of post-referendum discussion. A previous witness has indicated to us that you have a kind of vote in principle through a referendum, and having had the vote in principle you then end up in several years of negotiation about what that actually means. You have raised a whole set of issues around debt, defence and other matters, EU membership and so on. To what extent do you think it is important that people voting in a referendum actually have answers to a lot of these fundamental questions before they cast a vote?

**Professor McCrone:** I think it is important they have answers to as many of them as is practical, but I do not suppose they can have answers to them all, because if independence was agreed, it would have to be followed by this negotiation, and a lot of these things would then become clearer. That is why some people say there would need to be two referenda, which I personally do not favour, but there is a view that once the terms are negotiated the Scots should be asked again whether they still think it is a good idea. I think once you have got that distance down the road there is no turning back. So I think that would be a problem. There are things that would become clearer after the vote once the negotiations start, some of which might hit people quite hard and they think, “Oh, we had not thought about that”.

**Q138 Lord Shipley:** But if there was to be only one referendum, which you seem to support, could you identify what the issues are that you think need to be clear before that takes place?

**Professor McCrone:** One of the things that I would like to see clearer, I must say, is when the present Scottish Government say that they want independence because they want the levers to be able to manage the economy better, what they actually have in mind, because there are a lot of things they can do at present. If what they mean by that is cutting corporation tax by a huge amount or something, then what the implications of that would be needs to be explored. It would reduce their revenue for a start. Even if it worked to attract
industry, it would take quite a long time for that to have an effect. It would be quite likely to lead, I think, to some sort of retaliation, because the European Union would not like it for a start, and the British Government would not like it. It depends how much they cut it by.

The Holtham commission in Wales suggested that you could cut corporation tax, but they had a formula for doing it. If the income of an area was less than 80% or something of the national average, then the corporation tax could be cut by 10% or something, as a kind of stimulus to help it. That was a formalised way of doing it. Scotland would not be in that position because its GDP per head is more or less the national average, and if it cut corporation tax by a significant amount, I think there would be great friction with parts of England that are more disadvantaged at the moment than Scotland is.

Lord Lawson of Blaby: I have a question on corporation tax.

The Chairman: But there are others wanting to ask questions as well.

Q139 Lord Lawson of Blaby: Very quickly, it is quite clear, is it not, that if an independent Scotland wished to join the European Union, one of the conditions that the European Union would make is that they do not follow the Irish down that route. There is no way, because they are very sensitive about that.

Professor McCrone: I would have thought that is right, actually. They do not like the Irish doing it.

Lord Lawson of Blaby: Exactly.

Professor McCrone: So I do not think that they would be very happy for the Scots to do it too.

Q140 Lord McFall of Alcluith: You mentioned devo max. What about full fiscal autonomy—would that work? What is full fiscal autonomy, can you tell me?

Professor McCrone: I think it is devo max, is it not? Part of the advantage of belonging to a country is that the stronger bits help the weaker bits, and that is why we had regional policy. Well, we still have regional policy. I was rather sorry that it was not kept at a higher strength than it is, because I felt that it was doing quite a lot of good. If you are entirely dependent on your own fiscal revenue, then you are saying, “Well, we will stand on our own feet and we do not want any transfers from you, thank you very much”. That means you are much more exposed to fluctuations in taxation revenue. Scotland would have quite a lot of its taxation revenue coming from North Sea oil, and that has been a very volatile source of revenue in the past. It has been as high as £12 billion in recent years and as low as just under £1 billion in the 1990s. If you go back to 1984 when it was £12 billion then, that is the equivalent of nearly £30 billion now. So it has been very volatile, and if Scotland was depending on that as one of its main sources of revenue, then its budget would be liable to fluctuate quite a bit, which I think would be difficult.

Q141 Lord McFall of Alcluith: In an independent Scotland, if you have a currency link with sterling, would that allow quite a lot of fiscal latitude, do you think?

Professor McCrone: I do not think so, actually. Ministers in the Scottish Government have said, yes, they would have freedom in fiscal policy, but they would be in a monetary union. I think if we have learned anything from what is happening in Europe at the moment it is that that does not really work. When Ireland became independent, it retained the link with sterling. There were not as many speculators around then as there are now. The Irish, oddly
enough, did not seem to have any lender of last resort, because I do not think that was ever negotiated, but they kept a very tight, conservative, orthodox fiscal policy, and one of the consequences was the Irish economy was stagnant for about 20 years.

The Chairman: We will come on to the currency issues in a moment. Lord Forsyth?

Q142 Lord Forsyth of Drumlean: I want to come back to the point that Lord Shipley was raising about whether we might have a period of two or three years of negotiation where everything was up in the air. You have experience of dealing with the changes that occurred with the collapse of the old coal, steel and shipbuilding located in Scotland and inward investment and everything else, and I notice that in one of your articles you place great emphasis on trying to develop small businesses as the way forward. What do you think the impact would be on confidence—I am trying not to make this a leading question—and on investment of just having that period of three years of uncertainty, with claim and counterclaim? Although I have a view about independence, this aspect of the thing is something that I had not really considered, but it seems to me to be quite profound in terms of its potential impact.

Professor McCrone: I think that is right. I have been told that when Quebec was lumbering up to having its independence referendum that resulted in a lot of investment switching to Toronto rather than going to Montreal. I have not seen any of that effect so far, but I think one would have to be aware that that would be a possibility.

Lord Forsyth of Drumlean: I am thinking that, if there is a referendum and people vote, and we then have two or three years of that—

Professor McCrone: How is it going to work? Yes, I think that is right. If it happened in Canada before the referendum, then if the referendum had actually gone through and they then had to negotiate their independence, I would have thought the effect would have been even stronger afterwards until the whole thing was settled. Once it was settled it might be all right, but then questions like “Would Scotland be in the European Union?” and all that kind of thing would affect business decisions.

Q143 Lord Hollick: Could we come to the question of currency. You say in your article “Greek Lessons for a Scottish Government” that this is one of the issues that needs to be considered and explained before we vote in a referendum. You also make the point that the declared option of staying with sterling would be far from a simple matter for an independent Scotland and how that was dealt with would have major implications for the economy. Retain sterling, join the euro or have the groat—there are a number of options. Would you like to take us through your views on each of those?

Professor McCrone: The original position of SNP Ministers was that Scotland would have a referendum and if the referendum was favourable on the issue they would join the euro. I think people are less enthusiastic about that now, and I would have thought members of the eurozone would not particularly welcome another member either. So I think that is off the table for the time being. Alex Salmond has said that his intention now would be to retain the link with sterling. The reason why I say that is not a simple matter is you then have to consider whether there is a lender of last resort and whether the Bank of England is prepared to be that. Why should it? What implications does that then have for Scottish fiscal policy?

I happen to think that the Germans have misdiagnosed the problem in the eurozone in thinking that it is all to do with Governments overspending. The Irish and the Spanish had lower debt than Germany before this crisis came and their budgets were in surplus, so that if
there had been strong rules, it would not have caught them. The problem in those two countries was excessive private borrowing, not excessive public borrowing.

But nevertheless, all these things have to be looked at if you are going to make a monetary union work, it seems to me. I do not think Scotland could just do whatever the hell it liked in terms of fiscal policy. It would have to stick by some sort of rules as regards its budget deficit and also things like private borrowing.

**Q144 Lord Hollick:** One lesson that one could draw from the current problems of the eurozone is that, absent central institutions and absent a fiscal and monetary policy right across the union itself, when the pressure or crisis comes, it is extremely difficult to manage the situation. Remaining part of the United Kingdom in the sense of having sterling would deprive, it would seem to me, Scotland from having the levers to manage its economy.

**Professor McCrone:** Yes, to a large extent that is probably true. It would have a few more levers maybe than it has now, but yes, it would mean that fiscal policy would have to be fairly tightly constrained, I think. It is interesting that in Ireland it took them quite a long time to do anything much about the link with sterling. They just carried on as they were before independence for quite a long time. The Irish banks continued to print notes just as they had done before, like the Scottish banks do now, and much of the money was invested in Treasury bonds in this country. Then they decided that they ought to have their own currency—the Free State pound as it was called—which was introduced, I think, in the 1930s. Not until 1942 did they pass an Act setting up a central bank, which then became effective in 1943. So, Ireland became independent in 1922, but it was not until 1943 that they actually had a central bank, I suppose because they realised, “We had better, after all, have a lender of last resort”. The Irish currency was exchangeable, Irish pound for British pound, at par, but it was technically, after they started their own currency, a different currency, and that meant that when they got to the stage where they were going to join the European exchange rate mechanism it was much easier just to break the monetary union with the UK than it would have been if they had still been using Bank of England currency.

**Q145 Lord Hollick:** Have you given any thought to the consequences of having a groat or a Scottish currency?

**Professor McCrone:** A Scottish currency?

**Lord Hollick:** A Scottish currency, and in particular its impact on the ability of Scotland to fund itself in the bond markets.

**Professor McCrone:** I am inclined to think that, if Scotland did become independent and wanted to keep the link with sterling, it ought to start its own currency and keep it on a par so that if there was a real serious crisis it could be decoupled without too much difficulty. Part of the trouble we have seen in the euro is that you cannot do that. There is no reason why a small country should not have its own currency. After all, Norway does and Denmark does. Lots of countries that are smaller than Scotland have their currency, but they usually tend to have it fairly closely linked to some other currency of a bigger country. Switzerland, I suppose, is the most successful example of a small country with its own currency, so it is perfectly feasible to do it.

Whether that would affect Scottish Government bonds depends on whether the market has reasonable confidence in their ability to repay the bonds when they mature. The reason that there is trouble in Europe at the moment, it seems to me, is that people do not have that confidence. The reason why in the United Kingdom the interest rates are so low on government bonds is that people do think that they can do that, partly because they control
their own currency so they could print more of it if necessary. That is partly how it works, but a country like Greece or Spain cannot do that—hence the concern about the price of bonds.

Q146 The Chairman: If you look at the position of Spain at the moment, they have the particular problem in relation to their banks. In the situation you are envisaging, if the Royal Bank of Scotland and HBOS were still Scottish banks, what would happen there?

Professor McCrone: This is quite interesting. There is an interesting example of what happened with Iceland, because Iceland had two banks that were heavily involved in the United Kingdom. I cannot remember which was which but one of them operated through a subsidiary and the other operated through a branch. The one that operated through a subsidiary was regulated by the British authorities and so when the bank in Iceland went bust it was the British Government, I suppose, that was actually responsible for funding the depositors through the guarantee scheme. The one that operated in a branch did not have that so there was then a difficult negotiation—I do not know whether it has concluded even now—between the British and Dutch Governments to try to get the Icelanders, of whom there are only 300,000, to pay up on the money that had been lost in the United Kingdom. The lesson of that, it seems to me, is that if a Scottish bank after independence was trading in England—say, the Royal Bank of Scotland—then it ought to make sure that NatWest is a proper English subsidiary, and therefore it would not be the Scottish taxpayer that would have to meet the cost if it actually went bust.

But consider what has happened in some cases in Europe. In Belgium, for example, Bank Fortis went bust and, because it was operating in several different countries, they all had to chip in and sort it out. I suppose that is what would happen. But there are great problems if you have banks that are too big for the country in which they are based.

Q147 Lord Forsyth of Drumlean: Just following on from that point, when we did our inquiry into the banking crisis the Governor of the Bank was very keen to make the argument that the relative size of the American economy and the large investment banks, compared to the UK, meant that we were a greater risk. Pulling together—without putting words into your mouth—what has just been said, it seems to me that if Scotland was going to have its own currency and raise its own bonds, it is likely that its credit rating would be less and, therefore, the cost of capital would be higher. Would it not make sense for banks like the Royal Bank of Scotland or some of the other big financial institutions that are operating in Scotland to move south because they might have some difficulty in raising their capital and they might provide a systemic threat to an independent Scotland's economy?

Professor McCrone: The latter point is the one that I would be most concerned about, I think. Iceland was an extreme example.

Lord Forsyth of Drumlean: Of course. They just defaulted, did they not?

Professor McCrone: Yes, they just defaulted. In the case of Ireland, the Irish Government decided to meet the cost of the bondholders, which I wish they had not done from their own point of view, actually, because that sank the Irish Government's budget as well. That is why I think it is very difficult if a bank becomes extended to the point at which it could imperil the country in which it is based.

Q148 Lord Forsyth of Drumlean: Given that the financial sector is so important to Edinburgh and Glasgow, how do you think an independent Scotland could operate? Would
we have one UK regulator, or would they have to set up their own regulatory regime? If it was different, that is going to impose costs and—

**Professor McCrone:** I think they would have to set up their own regime.

**Q149 Lord Forsyth of Drumlean:** Would that not create an incentive for companies like the Royal Bank or other large financial institutions to have one regulatory regime by being based south of the border rather than north of the border?

**Professor McCrone:** They would also have to have one in Scotland if they were operating in Scotland.

**Q150 Lord Forsyth of Drumlean:** My point is: why would they want to operate in Scotland in these circumstances?

**Professor McCrone:** What, at all you mean?

**Lord Forsyth of Drumlean:** Yes, because the costs of running a regulatory regime are not insignificant. Is there a risk there?

**Professor McCrone:** I think there probably is, and I think this could affect the insurance companies as well, like Standard Life and Scottish Widows, which do a substantial amount of their business south of the border. These are things that would have to be thought about quite carefully, because it could have major implications on employment in Scotland.

**Q151 Lord Forsyth of Drumlean:** If you just take that slightly further to the macro view, a lot of people in England will say, “Well, if Scotland wants to be independent, that is a matter for them, and they can sort out their affairs and so on”. But, because of the importance of trade cross-border within the United Kingdom and also because of the extent of these financial institutions, in practice, if Scotland were an independent country, to what extent would it still be a problem for England insofar as, rather like the Royal Bank of Scotland was too big to fail, Scotland itself as an economy would be too big to fail? How could the rest of the UK Treasury prepare itself for that kind of situation?

**Professor McCrone:** I had not really thought of that happening. I can see that there is a risk with the financial institutions and one would have to decide how they were going to be run.

**Lord Forsyth of Drumlean:** Or if the oil price collapsed.

**Professor McCrone:** Yes, if the oil price collapsed. I would assume that if the oil price collapsed, there would be one hell of a belt tightening in Scotland. The Scottish Government have said that the revenues from North Sea oil ought to be put into a special fund, like the Norwegians have done. I agree with that, actually. I wish, therefore, we had done that when we found the oil in the first place. In fact, I remember writing a paper for the Treasury at the time advocating that. But we did not do that and so we have been using our capital asset to fund current expenditure, which I think has been a bad thing to do. If we had had a fund like the Norwegians have, a sovereign wealth fund, our present situation would have been a good deal easier than it is, it seems to me.

That is what the Scottish Government say they would like to do, but I do not see how they can do it in the present budgetary situation. They would have to get the economy really working a lot better and generating a lot more revenue before they could afford not just to use the oil revenues to balance their budgets.

**Q152 Lord Forsyth of Drumlean:** Yes, because you cannot spend the money twice.
Professor McCrone: No, you cannot spend the money twice.

Lord Forsyth of Drumlean: The same argument applies with corporation tax. But just on my point, in practice, just as the freedom for manoeuvre for the Scottish Government in terms of fiscal policy would be limited, looking at it from the other side of the border, is it wrong to imagine that Scotland would no longer be the rest of the UK’s problem? I think the UK would have a very considerable economic interest in what was happening to an independent Scotland north of the border. Just as, conversely, the Scottish Government’s freedom for manoeuvre would be rather limited in practice, the rest of the UK would still carry responsibilities for what was going on in Scotland. Is that wrong?

Professor McCrone: I am not sure. I do not think the UK Government has worried very much about what happens in Ireland as an independent country.

Lord Forsyth of Drumlean: We have just lent them—

Professor McCrone: I know, yes. That is true, but generally speaking I do not think it has made a great impact. I think you have to assume that Scotland might get into some terrible mess before you think that would happen.

Q153 Lord Forsyth of Drumlean: If we imagine, for example, that we had not had the economic crisis, Scotland became independent, the Bank of Scotland and HBOS were still there, and the financial crisis came along, Scotland would be in very grave difficulty. It seems to me that when people who say, “Well, that would be a matter for the Scots”, it would be very difficult for the rest of the UK.

Professor McCrone: No, that is quite true, but if they had had the wisdom to ensure that NatWest was a subsidiary and Halifax was a subsidiary, then it seems to me that the main burden of dealing with that would fall on the Government in London.

Q154 Lord Tugendhat: We can see the parameters of the issue that Lord Forsyth is raising in what happened in the case of Ireland before Christmas. Ireland got into very serious difficulties, the British Government decided that Ireland was in a different category from other eurozone countries and that Britain would give a helping hand. But the helping hand was not as big as all that, and the decision was quite a controversial one. I personally supported it, but not everybody did. A lot of people felt that, since the Irish had chosen to go into the euro, they should live with the consequences. It seems to me that the parameters are very similar in this case. If the Scots have decided to go their own way and feel they can run things better by themselves than as part of the United Kingdom, I suspect that British political opinion would not be feeling particularly generous. No doubt if there was a catastrophe some help would be forthcoming, but I suspect that the more the Scots have talked about how much better they could run things by themselves, the less willing the English would be to help if anything went wrong.

Professor McCrone: Yes, I am sure that is true. In the case of Ireland, I think the British Government did it mainly out of self-interest rather than altruism, I suspect, because Ireland was an important economy as far as the UK economy is concerned and the links between the two. It did not want Ireland totally impoverished, because that would affect British trade with Ireland, and that would apply to Scotland as well. But that would be the sort of basis—

Q155 Lord Tugendhat: Absolutely. But whereas I thought it was a very good idea to support the Irish, I recollect there were a lot of people in the House of Commons who took a contrary view.
**Professor McCrone:** Yes.

**The Chairman:** I think we must move on.

**Q156 Lord Levene of Portsoken:** Do you expect an independent Scotland will seek to introduce different corporation and personal tax rates from those that apply in the rest of the UK?

**Professor McCrone:** I think what would happen at the beginning is that there would not be much change, but I think it would want to. From what they have said, they would want to cut corporation tax, but they would not be able to afford to cut it very much to start off with. That is why we discussed corporation tax before, because I think that is quite a tricky issue. As for personal tax, I think over time personal taxation in Scotland would be different from England, just as it is in Ireland. But I think to begin with there would be quite a lot of resistance to putting taxes up in Scotland, for instance, if they were not being put up in England. Cutting them may be a different story, but then I do not think they could afford to do that very readily.

**Q157 Lord Levene of Portsoken:** Under the EU rules, is this feasible? Would there be sufficient capacity in the budget to introduce any substantial changes in the tax rates?

**Professor McCrone:** Not at the moment. You might decide to do it differently, to put more on VAT and less on something else, for instance, or less on VAT and more on something else. Those kinds of decisions could be taken. But I think as far as the overall budget is concerned, if what you are suggesting is they might want to run a deficit or something then I think that would be very difficult in present circumstances, because there is a deficit in the UK already, and Scotland shares in that.

**Q158 Lord Levene of Portsoken:** If they were pursuing the devo max option, how would you expect the competing wishes for fiscal autonomy and potentially damaging tax competition to be balanced out?

**Professor McCrone:** Under devo max, Scotland would still be part of the United Kingdom and it would still be part of the monetary union. That would only work if there were pretty tight rules that prevented Scotland playing fast and loose with its fiscal policy. I think there would be a lot of rigidity there that would be difficult for anybody to overcome. I do not think this has been understood yet. I think there is still a view in Scotland, “Oh well, we could do all kinds of things with fiscal policy and still remain in the monetary union”, and I do not think that that is the case. We might have thought that 10 years ago, but the events in Europe in the last few years I think have shown that you cannot do that.

**Q159 Lord Levene of Portsoken:** So somehow or other you would need some sort of uber-referee to tell them what the rules were before you started?

**Professor McCrone:** Yes.

**Q160 Baroness Kingsmill:** However, there could be something that is short of full independence. This whole thing could be a negotiating stance, could it not, to get more powers but be short of independence?

**Professor McCrone:** You could go further than the Calman proposals. It is quite interesting; Calman said that the Scottish Government should have a share of the income tax but not all the income tax. Why did they say not all the income tax? Because they thought no government should be overdependent on one source of revenue. But you could overlook
that and say, “Well, let them have all their income tax”. You could assign corporation tax. You could not have a different rate, but you could assign the revenue from corporation tax. If you did those two things, that would cover the bulk of the Scottish public expenditure at the moment that has devolved, so the block grant element would then be very small, but the revenue flow would be a bit more volatile than it is under the present arrangements.

Q161 Baroness Kingsmill: Yes, it would, but it could also be a negotiation over oil revenues, for example, a greater sharing—

Professor McCrone: Yes. That would be quite a difficult negotiation, I think.

Q162 Baroness Kingsmill: Yes, but I think on the devo max point, which is what I am getting at, “devo max” has become one of those loose phrases. As you said, nobody really understands exactly what it means. You do not have to go as far as a declaration of independence for Scotland to get more powers than it already has that fall short of devo max or whatever but—equally but more importantly—fall short of complete independence but give them more of a free hand in the way that they run their own economy. You can imagine a situation where, in issues over tax and issues over oil revenues, a better deal could get negotiated.

Professor McCrone: Yes. I think any negotiation over North Sea oil will be fraught with difficulty, because the Scottish Government will be saying, “Well, if we are independent, we would get 90% of it”. That would be their starting point. “So why should we agree to anything less?” That would be the sort of starting point that they would go from.

The Chairman: Baroness Kingsmill, can we move on to the next subject?

Q163 Baroness Kingsmill: Yes, of course. Do you think that an independent Scottish Government that issues its own debt would face higher borrowing costs than the UK? What do you think would happen to borrowing costs on either side of the border in the event of independence?

Professor McCrone: I think south of the border there would not be much difference, actually. As far as the rest of the UK is concerned, it would not get the oil revenues, but then there would be no transfer to Scotland where presently there is. Under the Barnett formula this is very controversial. The English think they subsidise Scotland and the Scots think they subsidise England because of the oil revenues. That is really the way it works. But anyhow if there is a subsidy it would disappear. It would sort of balance out.

Q164 Baroness Kingsmill: What about the markets? What about the capital markets?

Professor McCrone: As far as the markets are concerned, I do not think the markets would be affected very much for English debt—or the rest of UK debt, let us say. As for the Scottish debt, I think it is possible to say that a smaller country might have more difficulty, but on the other hand it would depend on how they ran themselves. The Swiss can run themselves perfectly satisfactorily and have very low interest rates, and so can the Norwegians. So it can be done.

Q165 Lord Lawson of Blaby: But is that not the point that there is likely to be a difference between the initial impact and the long-term impact? If over a period of years an independent Scotland built up a track record of prudent fiscal policy and so on, then there is no reason on earth why its debt should be ill thought of in the financial markets. But initially, before it has built up that track record, there would bound to be considerable doubt and
uncertainty, which would have the result that Scottish debt would have to give a significantly higher rate of interest to the holders than United Kingdom debt, which has this long track record as the only country in the world that has never defaulted.

Professor McCrone: The Scots would, of course, be saying, “Well, we have all this oil and that is going to generate revenues and that puts us in a very strong position”, and so on, but actually they would have a problem because the oil really would be necessary to balance the budget for the moment; in fact, not balance it, because there is a deficit, but it would be an important part of their revenue and not something extra. Initially, I think there could be a problem until people saw what the Scottish Government was going to do. I do not think that Ireland had a particular problem, but that was because they were incredibly conservative about the way in which they ran their public finances. I need to learn a bit more about this, but as far as I can make out the Irish did not issue very much debt to begin with.

Lord Lawson of Blaby: That is right.

Professor McCrone: People kept buying Treasury bonds from this country.

Q166 Lord Lipsey: If you had a debt crisis in Scotland, what would be the impact on the rest of the United Kingdom? Are there ways of avoiding such a crisis coming along, like by new fiscal rules on both countries?

Professor McCrone: Well, if it was in the monetary union, I think there would have to be rules. The eurozone is trying to invent tougher rules—I think to some extent misguided rules, actually, because I do not think that more and more austerity is the answer in their case. But there would clearly have to be rules, otherwise the monetary union would not work. I think that the Bank of England would refuse to be lender of last resort unless it was satisfied that there were rules in place. There would have to be a negotiation about that, and it is not immediately obvious why the Bank of England should agree to be lender of last resort. It would certainly have to be satisfied that the markets in Scotland were not going to upset the whole basis on which sterling was being put on the market. I think that, as I said earlier, one of the reasons that interest rates on sterling bonds are so low is because the Bank of England has bought up such a lot of them. There is a question as to what would happen in Scotland in that sort of situation; would a Scottish central bank be buying up government bonds in Scotland or not? This is all hypothetical. You cannot really come to a view about it at the moment.

Q167 Lord Lipsey: Taking a parallel, countries get very cross when the IMF imposes discipline on them in a way that they might not be if their own central bank imposed a similar level of discipline. It is one thing for Scotland to accept the role of the Bank of England at the moment. If they wanted to do something and the Bank of England said no, is that not going to reignite all the problems that caused the movement for devolution in the first place?

Professor McCrone: Yes, I think it would.

Q168 Lord Shipley: Could I pursue the question of dependency on oil revenues, and really from two respects? You said in your evidence that you think about 90% or so would apply to an independent Scotland. I have two questions about this. The first is: do you think that the non-oil sectors of an independent Scottish economy might be weakened because of the enormity of the oil sector? Secondly, what happens if oil revenues fall due to uneconomical reserves? Might there be offsetting improvement in the non-oil economy or might that be a problem? The reason I ask this is in an article you published on 22 March this
year you do say, “Despite considerable efforts, Scotland has been much less successful in promoting the growth of new indigenous industry, and that should be a major concern”. Could you just elaborate on this dependency upon oil revenues and what happens if they decline?

Professor McCrone: Yes. I was very concerned in the early 1980s that the effect of North Sea oil through the British balance of payments would push up the exchange rate for the pound, which indeed it did and contributed, I think, to the fact that a lot of the non-oil sector found itself in difficulty at that time. There were two things that happened. There was a very tight monetary policy imposed but there was also the North Sea oil effect. The Dutch had the same thing with natural gas. It was called the Dutch disease for a while, and their exchange rate was too high for the rest of the economy. I do not think that that is a problem at the moment in Scotland, but it could become a problem, of course, if the price of oil skyrocketed and that forced the exchange rate up. It is terribly important that it should not damage the rest of the economy because you cannot successfully run an economy if it is overdependent on one sector. I would attach a lot of importance to trying to ensure that the non-oil economy actually grew.

The reason that I made that point about indigenous growth was that Scotland has been successful under regional policy for many years in attracting foreign investment. What it has not been so successful at is generating investment from its own domestic resources. The business start-up rate is disappointing. Those that start up anything do not fail as much as they do in some other parts of the UK, but the actual start-up rate is disappointing. It is very important to see what you can do about that. It is very difficult. There have been all sorts of schemes and efforts made by Scottish Enterprise, and the Scottish Development Agency before it, to try to generate more growth from indigenous sources. Scotland at one time was very good at generating growth from indigenous sources in the 19th century—in the industrial revolution. We were in the forefront of all that, but we have not been so good at it in recent years, and that is very disappointing. We need to try to do something about it.

Q169 Lord McFall of Alcluith: It could be an effect that independence would generate a wave of entrepreneurship and enthusiasm.

Professor McCrone: Well, one would hope so.

Lord McFall of Alcluith: But is there a basis of fact for that?

Professor McCrone: I do not think so, really. One would hope that something like that might happen. I think what is interesting is that one of the reasons why the German economy is so successful is that it has a very successful small business sector. We need to see why that is and what we can do to be equally successful. This is not just a Scottish problem; it is a UK problem.

Q170 Lord Shipley: On the issue of foreign-firm investment in Scotland, supposing that Scotland became independent, do you have a view as to whether foreign firms would be more likely to want to come to Scotland, maybe to buy Scottish companies, or would they be less likely to because of the smaller nature of that country and economy? Is it likely to see foreign firms keener to invest elsewhere?

Professor McCrone: I do not think that should happen. It might happen, but the example of Ireland is that Ireland was very successful in attracting foreign investment. In fact, in Scotland we regarded Ireland as our main competitor for a long time. Both countries were pretty successful in attracting foreign investment. Scotland was rather hit when the electronics industry turned down, because so much of the growth that had come was actually in the
electronics industry. Ireland, of course, has been hit by this recent crisis. But I do not think the size of Scotland is the problem.

Access to the European Union is a major issue. If there was no access to the European Union, of course, you could forget it. Whether Scotland was a member of the European Union or just of the European Economic Area, it would presumably have free trade access to the European Union. That would be crucial, in my view, and that is why Ireland did so well after it joined the European Union in attracting foreign investment. It would not have done it otherwise. That is the kind of issue that is important here.

**Q171 Lord Tugendhat:** Would you agree with me that Ireland was very successful at attracting investment—and Scotland, too, and Spain as well—because companies in North America and Japan and elsewhere, and indeed within the European Union, saw these as very good places to put plants in order to export to the European Union? The European Union was seen as a rapidly developing market. Obviously, one consequence of what is happening in the European Union now is that the attractions of the European Union as a market are less and, therefore, in a sense the biggest single selling point that Spain and Ireland and Scotland had has been diminished. Scotland or Ireland is not the place in which you would necessarily put a plant in order to export to India.

**Professor McCrone:** No, but at least we do not have the disadvantage of being in the single currency. Whatever happens in Europe, the European Union is going to be Britain’s main trading partner, and I should have thought that will continue. There may be, for a time, difficulty about it because incomes will be depressed and trade will, therefore, be depressed, but it will remain the main trading partner. I should have thought that anyone who was thinking of investing in Europe would still consider a location in Scotland as an appropriate place to be, particularly I suppose because there is not the eurozone crisis affecting it at the moment.

**Lord Tugendhat:** I should, of course, have mentioned England, because England has also been very successful in attracting—

**Professor McCrone:** Yes, and England too.

**Q172 Lord Smith of Clifton:** This is really related to our previous questions. Do you expect Scottish independence to affect the underlying growth rate of the Scottish economy and/or that of the rest of the UK? By what mechanism might this occur? Are there any lessons from other international separations? This goes back to whether there will be a confident upsurge in flair, entrepreneurship and other such attributes.

**Professor McCrone:** Well, I do not think the rest of the United Kingdom would be much affected, actually. I think it is very difficult to predict for Scotland. As Lord McFall said, there might be an upsurge of enthusiasm: “Now we have an independent Scotland we can do all sorts of things”. I think that is possible, but I find it very hard to find anything concrete that could assure one of that. Apart from that, a lot depends on how a Scottish Government behaves and how it organises things. If, for example, it went all out to try to promote new business start-ups and learnt some lessons from Germany and improved the training system, as the Germans have done, and all the rest of it, this could have a considerable effect on economic growth. But they can do those things at the moment. They do not actually need independence to do that.
Q173 Lord Smith of Clifton: Do you think there might be a flight of highly skilled labour from Scotland, either south of the border or elsewhere? Will there be another outflow of migration from Scotland?

Professor McCrone: I think that would only happen if conditions in Scotland were bad and people went elsewhere to find work.

Q174 Lord Smith of Clifton: But if the turbulence that is created with the possibility of that—it has happened in Ireland now again with the downturn.

Professor McCrone: Yes, of course, but that is because of what has happened to the Irish economy. If the Scottish economy went through some crisis of that kind, then the same kind of thing would happen. But equally, if the Scottish economy happened to do very well, then I think it would attract more people back, just as Ireland was doing. Ireland’s flow was inward rather than outward for a number of years when the Irish economy was doing well.

Lord Smith of Clifton: During the Celtic tiger times.

Professor McCrone: There are quite a lot of people who would probably like to go back to Scotland and work there if the jobs were available. It really depends how they are doing.

Q175 Lord Hollick: You mentioned—and, indeed, other witnesses have done the same—that Scotland rather underperforms in some respects on the level of economic growth and development that it possibly should be achieving. You have also made the point that Denmark and Norway, two other independent countries with their own currencies, have done rather well. What is it about those countries, and what lessons can you learn from those countries, which could be applied to Scotland? Does Scotland need to be independent to take advantage of those lessons, or can it do it as part of the United Kingdom?

Professor McCrone: I think probably the latter. Has Scotland been doing badly? A lot of people say yes. The present Scottish Government says its performance has been unsatisfactory for a long time, but actually if you look at GDP per head, that is not true. I wrote a paper in 1974, which I think may have been circulated. On reading it again, what struck me about it was how much better off, relatively, Scotland is now than it was then. We now have a GDP per head that is approximately the UK average, above that of the north of England, Wales and Northern Ireland and even the north-west of England—in fact above all the other English regions except the south-east. We have unemployment at the British average. When I joined the Scottish Office in 1970, Scottish unemployment was way above the British average and at one time had been double the British average. In those respects, there has been considerable improvement in Scotland’s relative position. Going back to that paper that I wrote in 1974, I was rather struck by the fact that there had been a big improvement since then, relatively speaking. Scotland’s rate of economic growth has not been as high as the UK’s, but then its population has not grown as much as the UK’s. You have a GDP per head that has actually been able to improve in relation to the UK average over those years. Yes, in some respects it is not satisfactory and could have been better, but it is not as bad as a lot of people make out.

As for learning lessons from other countries, I am all in favour of that but I think you need to study the particular circumstances that have enabled them to do what they do. I think Scotland was very much dragged down by the decline of the older heavy industries for a long time, and that did not apply for a country like Denmark in the same way. We were tremendously dependent on coal, steel, shipbuilding, heavy engineering and textiles, and all of
these declined. That decline is mostly a thing of the past now, but it took a tremendous amount to make up for that. That was a considerable legacy, which had been very successful at one time but which Scotland had to overcome, mainly in the 1960s and 1970s and into the 1980s. There are now very few shipyards. There is virtually no steel industry. The coal industry has gone, except for opencast, and textiles have greatly diminished as well. That is all very sad, but it means that from this point onwards those are no longer a drag on the economy.

Q176 Lord Forsyth of Drumlean: On that point, I think you and your colleagues in the Scottish Office deserve a lot of credit for the way you dealt with the transformation of the Scottish economy from one being dependent on the industries of the past and brought in new industry and new prosperity. It may just be my political prejudice, but do you think that perhaps the Scottish economy is overly dependent on public expenditure? I remember, for example, being asked, when Michael Hirst lost his seat in Bearsden, “How is it that the most middle-class seat in Britain has been lost by a Conservative to Labour?” The answer was that we were controlling public expenditure, and so many of the people who lived in Bearsden were employed by the public sector. I am not making a party-political point; I am just trying to illustrate the point. If you look at the way in which Scotland operates and you also look at the relative additional expenditure in health and education and compare the improvement in productivity with that in England, I wonder if that is part of the problem—that there is still too much dependency on public sector financial support.

Professor McCrone: I think that is true. Scotland has had what I regard as a pretty good deal on public expenditure for a long time. At the moment, the identifiable expenditure is about 17% above the UK average, according to the Calman figures. Gerry Holtham in his report on Wales said that the Barnett formula arrangements did not deliver enough to Wales but delivered too much to Scotland. We have never had a needs assessment done since the late 1970s. If you are going to have public expenditure related to needs, we do not really know what that would throw up, but most people suspect that it would not justify the level of public expenditure that we are presently getting from the UK Exchequer.

I would like to see Scotland able to operate with less dependency on the public sector, certainly, but of course you need to get the rest of the economy to grow in order to make that easily accomplished. It would be much easier to do in a period when public expenditure generally in the UK is growing rather than in the present type of situation where it would just add to the cuts. But hardly anybody seems to understand the Barnett formula, certainly in Scotland. I used to say it is like the Schleswig-Holstein question. The Barnett formula is really just a population ratio, but it only applies to the increment or decrement. I am sure you are well aware of this, having been Secretary of State for Scotland.

Lord Forsyth of Drumlean: And also how to get round it.

Q177 The Chairman: The Lords did a special report on the Barnett formula, as you know.

Professor McCrone: Yes, that is right. Well, it was thought there would be a Barnett squeeze, which would narrow the gap between the territories and the UK average. It seems to have done that for Wales and Northern Ireland but not really for Scotland. I do not think that can last forever. The Holtham committee has raised the question now. The UK Government has said it has no plans to revise the Barnett formula, but I just cannot believe that it will last forever. The present time is not a good time to unpick it, but sooner or later
Scotland needs to have a level of public expenditure that can be justified on the basis of need and not just an obscure formula that nobody understands.

Q178  **Lord Forsyth of Drumlean**: I am not usually a proponent of higher public expenditure, but my difficulty in terms of Scotland, because this is not understood, is this: is there not a danger that people will walk into independence not realising the extent to which they have benefited from that transfer before they have in place the transitional arrangements that are necessary?

**Professor McCrone**: Yes, I think that is a danger, and if you tell them, people will not believe it anyway.

**Lord Forsyth of Drumlean**: That has certainly been my experience.

**The Chairman**: It is very difficult to get people elsewhere in the United Kingdom, especially in England, to understand the Barnett formula as well.

**Professor McCrone**: Yes. Well, they mostly think Scotland gets far too much money.

**The Chairman**: Yes, they do. They have that bit.

Q179  **Lord Tugendhat**: Before I ask the question I am scheduled to ask, I wonder whether—I had to leave the room for a moment—I have understood you correctly in something you said earlier. What I understood you to say was that independence may or may not turn out to be economically beneficial to Scotland and it will depend on the actions of the Scottish Government as to whether it is or not. But given the relative size of Scotland on the one hand and the rest of the United Kingdom on the other, whether Scotland makes a go of it or does not, it will not make much difference to the rest of the United Kingdom.

**Professor McCrone**: Yes.

**Lord Tugendhat**: I thought I understood you to say that.

**Professor McCrone**: That is what I think I meant to say. There is, of course, a lot of trade between them, and Scotland does more trade with England than anywhere else. If Scotland was doing very badly, then the English would sell less in Scotland, but it would not be a major issue for them, I do not imagine.

Q180  **Lord Tugendhat**: I just wanted to be sure I had understood. The question I am scheduled to ask you is: is membership of the European Union an essential part of the economic case for Scottish independence, or could one think that membership of the EEA was an alternative? I do not know whether that alternative is considered or not, but is the EU central to the case or would there be alternatives?

**Professor McCrone**: I should start by saying that I am personally a strong supporter of the European Union and have been for many years. I would not want to see Scotland outside the European Union, but that is mainly, I suppose, for political reasons. What is essential for Scotland is that it has free trade access with the European Union, it seems to me, because if we are heavily dependent on inward investment from elsewhere, that will not come if Scotland is at the disadvantage of not having free trade access to the rest of the European Union and England does have. At one stage, I could have envisaged, if Scotland was independent, it would stay in the European Union and England would leave, because there seemed to be a much stronger anti-EU feeling in England than in Scotland.
But I think that if Scotland did not get into the European Union, it would, I presume, be in the European Economic Area, and that would give it freedom of trade with the European Union. What it would lack is any voice in the councils of the European Union or in the decisions that European policy took. That is why countries like Sweden eventually decided to join, which had a great history of being very independent from everybody before. But then I suppose you have to ask yourself how much influence a small country like Scotland would have in the decisions taken by the European Union anyway.

There is one area that some Scots would think could be much better dealt with outside the European Union, and that is the fisheries policy. There is a lot of feeling in parts of Scotland—particularly in the north-east and, I suppose, in Shetland—about the common fisheries policy. I was involved in a study of the common fisheries policy done by the Royal Society of Edinburgh, and there is a lot of misunderstanding of it. The main people who catch the fish are the Scottish and British fishermen and they fish too much, and that is a large part of the problem. The stocks have gone down. It is not the Spaniards coming and pinching the fish. The Spaniards do not even have licences for the North Sea, only on the western side. There is a great deal of misunderstanding about it, but I think there probably would be a lot of people who thought, “Well, we would be much better managing our own fisheries policy”. But there would be problems even with that because you still have to share it. The North Sea is shared by a lot of different countries, so if you came out of the common fisheries policy, you would have to have bilateral arrangements with a whole lot of other countries. The Faroe Islands are different because they have their own little continental shelf, so they can have their own separate fisheries policy, although linked with Denmark. Of course, the same applies to Norway. But that is the one area, it seems to me, where Scotland would feel that there might be some possible advantage in not being in the European Union.

As far as the rest is concerned, I am sure there would be major advantage in being in the European Union. I think the SNP take that view. They did not originally. At one time they did not want to belong to anything, but I think increasingly they have felt that Scotland within Europe was what they wanted.

Q181 Lord Tugendhat: To what extent do you think Scotland draws any lessons from Catalonia, and the decision of Catalonia to remain part of Spain and, indeed, to exercise rather greater leverage in Madrid, perhaps, with its present status than it did before? Does the Catalonian example feature in the Scottish debate?

Professor McCrone: It does a bit. I do not know enough about it to say with any kind of authority what I think about it, but people often do quote Catalonia. They say, “Well, if Catalonia can do all these things, why can Scotland not do them?” and so on. Catalonia, of course, is the richest part of Spain, which is worth bearing in mind, and is very important, therefore, to the rest of Spain. I do not know what lessons one could learn from that. I do think they have powers to vary corporation tax and things like that there, but I do not know how extensive those powers are, and I do not know whether it gives rise to the kind of problems that I have been worrying about in relation to Scotland.

Q182 Lord Tugendhat: Although, of course, interestingly in the present crisis afflicting Spain, one of the things the Spanish Government, as I understand, is having to do is to restrict the financial freedom of action of Andalucia and Catalonia.
Professor McCrone: Yes. Well, I understood Catalonia was having to have the equivalent of a bailout or something from the rest of Spain, which is not a very good precedent for Scotland.

Q183 The Chairman: I had to deal with fisheries policy a long time ago. Can you just remind me what proportion of Scottish GNP now is coming from fisheries?

Professor McCrone: I do not have the figure. It is not huge.

The Chairman: It is quite low, is it?

Professor McCrone: Yes, it is quite low. It is quite low, but it is very, very important for certain communities on the north-east coast of Scotland and in Shetland especially.

The Chairman: I understand that, yes.

Professor McCrone: Those are the ones that are mainly affected. The fact that there have been problems in the industry has undoubtedly depressed these areas quite a bit—not Shetland so much, but the north-east coast of Scotland. It is a major concern there. I went to Shetland when they were scrapping some of the boats and it was a very sad business altogether. The pelagic fleet was doing reasonably well, but it is the white fish that are really the problem. I think the catch quotas are very difficult to work, because you cannot decree what fish you will catch. You may have plenty of quota for haddock but hardly any left for cod, and you cast the net overboard and it brings up cod. What are you supposed to do with it? That is what gives rise to all these discards and illegal landings and all sorts of things, which are a great problem with the fisheries policy and give it, of course, a great deal of ill publicity in Scotland as well as elsewhere.

Q184 Lord McFall of Alcluith: I was at a seminar in Parliament a number of months ago where Professor Nicholas Crafts of the LSE said that Scottish public services were grossly inefficient by miserable UK standards, and he referred to the health service. Do you agree with the proposition that it is the detail of what you do with taxes rather than the absolute level and what you spend your money on that is important? Could the Scottish Parliament have been more efficient in that over the past 10 years? Is there potential to increase that in future?

Professor McCrone: I would have thought there certainly is. I have never attempted to compare the efficiency of the Scottish public services with those in England. I happen to think, living in Edinburgh, that I am very well served by the National Health Service, better than I would be if I was in London, but that is maybe just prejudice.

Lord McFall of Alcluith: He was talking about an extra 90% expenditure per person in relation to that.

Professor McCrone: Yes, that is right. One of the things that has happened with devolution is that Scotland has stopped pulling all these things up by their roots and examining them. I think that has been a tendency in England that has been rather excessive sometimes. Things are always under review. When I did my report on teachers’ pay I remember that Ministers kept saying to me—it was the coalition of Labour and Liberal at that time—that they wanted to take another initiative in relation to the teachers and I said, “For God’s sake, do not. The one thing they are all complaining about is that they cannot cope with the ones they already have”. There is a lot of sense in leaving things be for a while, but certainly you do want always to try to improve the efficiency of what is delivered.
Q185 Lord McFall of Alcluith: Does Scotland have a choice in the future, say, between lower taxes and lower public services and higher taxes and higher public services? Comparisons have been made in the past when Ireland was going well that it was a relatively low economy, but we have a more social-democratic economy in Scotland. A choice has to be made there yet. Is that worth while exploring in the debate leading up to the referendum?

Professor McCrone: I think it probably is. I think at the moment there is a tendency for people to want Scandinavian-style social services but not that level of taxation. In fact, I think a lot of people in Scotland do not realise how high taxes are in Scandinavia.

Q186 Lord Lawson of Blaby: Going back to Lord Tugendhat’s question, which was about the European Economic Area and all that, you said—and many people are in the same camp—you were a strong supporter of the European Union but this was for political reasons. But, of course, what we are looking at in this Committee is the economics. Is it not the case that, although a number of important issues have been identified during the course of our discussion this afternoon, in economic terms access to the European market is probably the least important? Whether Scotland is a member of the European Union or a member of the European Economic Area or neither is not going to make much difference to access to the European market. We live in an era of globalisation, global free trade and freedom of capital movement. The WTO is there to regulate it. There is no impression and there is no evidence that the United States, which is not a member of the European Union, is unable to export to Europe, and there is no evidence that China—I am quoting just two big countries—is unable to export to Europe. Although the European single market may be of some marginal assistance, it surely is the least important of all the economic issues that we have been discussing today.

Professor McCrone: I have not tried to rank the issues in levels of importance. It is perfectly true, of course, that tariffs at one time were quite high around all these countries and they are not anymore, but I have always thought that it was very important for Scotland to be linked with the European Union in some way, because I think a lot of the foreign companies who came and invested in Scotland did so because of that.

Lord Lawson of Blaby: It was some time ago, though.

Professor McCrone: Yes, it was some time ago. Whether they would continue to come if we were not linked with the European Union I do not know. It is not just tariffs. There are all kinds of non-tariff barriers, which can be a problem and which the single market was all about. I would not like to try the experiment. I would rather Scotland stayed in the European Union so that we did not have to answer the question.

Q187 The Chairman: We have had a very interesting afternoon, and we have covered a lot of ground. Are there any other issues that we have left out that you would like to comment on?

Professor McCrone: I think we have covered everything pretty comprehensively, actually.

The Chairman: Well, Professor McCrone, thank you very much indeed for coming to us this afternoon. I think we have benefited from your long experience in these matters and particularly from an acutely Scottish perspective. We are very grateful to you. Thank you very much.

Professor McCrone: Thank you.
Dr Iain McLean FBA FRSE—Written evidence

Introduction

1. I am a professor of politics at Oxford University and a fellow of Nuffield College. I have been working for many years in the field of your inquiry. I am a Fellow of the British Academy and of the Royal Society of Edinburgh, and helped to organise the two academies’ double conference on these matters (in London in February 2012, and in Edinburgh in April 2012).

2. At those conferences, there were expert presentations on some of the subjects of your inquiry, especially about the economic fate of Ireland after 1921 and of the components of Czechoslovakia after 1992. I have asked for the transcripts to be sent to you separately. I could attempt a précis in oral evidence.

3. With that possible exception, my evidence concerns only QQ1-3 in your Call for Evidence. I am not qualified to comment on Q4.

4. I have written, and given evidence, elsewhere on the economic implications for Scotland of Scottish independence (see in particular my evidence to the 2007-11 Scottish Parliament Committee on the Scotland Bill), which I do not repeat here but can supply on demand. Therefore this evidence focuses on implications for the rest of the UK minus Scotland (RUK).

5. A general point to begin with: the economic implications per head for RUK of Scottish independence, whatever the detailed arrangements, will be much less than its economic implications per head for Scotland. This is for reasons of simple arithmetic. As the population of Scotland is less than 10 per cent of that of the UK, any changes in transfer payments between Scotland and RUK will have a trivial impact on taxing and spending in RUK. A perception that RUK is ‘subsidising’ Scotland may be politically relevant, but is not very relevant to your inquiry.

6. I broadly agree with the memorandum you have had from Prof. Robert Rowthorn. Where I have nothing to add to his analysis, I do not comment further.

Division of the UK’s public assets, liabilities and expenditure

7. The following supposes that the Scottish people have voted for independence, and analyses your questions in the context of the post-referendum discussions between representatives of Scotland and RUK. It also considers the contingency that a majority of voters in Orkney and Shetland have voted against independence. While this would have no legal or constitutional impact on the scenario, it would undoubtedly have an impact on post-referendum bargaining.

8. The division of non-defence-related public assets would be uncontroversial. They would be divided according to their physical location.

9. The division of defence-related assets would be controversial only if or insofar as the Government of RUK wished to retain a lease on assets in Scotland. The cases which have already been discussed are RAF Leuchars and Kinloss; and, most crucially HMNB
Clyde, essentially comprising the submarine base at Faslane and the armaments store at Coulport. As is well known, HMNB Clyde is the home of the United Kingdom’s strategic nuclear deterrent, in the form of nuclear submarines armed with Trident missiles. It is also one of the largest employment sites in Scotland.

10. Informal discussions suggest that both the current Scottish Government and the UK MoD regard HMNB Clyde as their trump card: i.e., in the event being discussed, each thinks that its card will force the other to make major concessions. They cannot both be right.

11. Traditionally, the policy of the Scottish National Party has opposed the siting of nuclear weapons in Scotland, and has stipulated that an independent Scotland would not be a member of NATO. The party’s leaders wish to change this last commitment, and are in the process of taking their proposal to their members. The results are unknown. Should party members reject their leaders, it would paradoxically strengthen the leaders’ hand in the event of independence negotiations, because the representatives of Scotland would be in a position to insist that the submarines and missiles must be removed from HMNB Clyde within an agreed timescale.

12. In that event, the commonly-known difficulty of finding a site in RUK which satisfies the operational requirements of the MoD and which avoids any highly controversial local opposition to new sites for the storage of nuclear warheads, in a timely manner, might force RUK to make concessions to Scotland on other matters.

13. However, it may be more enlightening to look at an aspect of the British-Irish agreement of 1921 that Prof. Rowthorn does not discuss. This is the creation of the “Treaty ports” of Berehaven, Queenstown (Cobh) and Lough Swilly. Article 7 of the Treaty states: The Government of the Irish Free State shall afford to His Majesty’s Imperial Forces (a) in the time of peace such harbour and other facilities as are indicated in the Annex hereto, or such other facilities as may from time to time be agreed between the British Government and the Government of the Irish Free State; and (b) in time of war or of strained relations with a Foreign Power such harbour and other facilities as the British Government may require for the purposes of such defence as aforesaid.

14. A similar arrangement was made between Russia and Ukraine after the break-up of the Soviet Union, to allow the Russian Black Sea Fleet to continue operating out of a base in Ukraine.

15. In 1921 the UK and Ireland had just fought a guerrilla war. The stakes were vastly higher than in the scenario being discussed in this memorandum. Nevertheless, the lead British and Irish negotiators on Article 7 (Winston Churchill and Lord Birkenhead for the UK; Michael Collins and Arthur Griffith for Ireland) were able to reach an agreement in which the smaller country accepted terms demanded by the larger for its military protection. Collins, the military leader of the Irish guerrilla forces, probably saw that the bases would allow the Irish Free State to take a “free ride” on defence provided by the UK against hostile third parties.

16. However, no government can bind its successor. Article 7 was renegotiated in 1938, and the UK Government relinquished control over the treaty ports. With hindsight, that was singularly badly timed. Likewise, the government of Ukraine, when controlled by anti-Russian parties, has given Russia notice to quit the base at Sevastopol.
17. It is also relevant that a non-nuclear weapon power may nevertheless be prepared to host nuclear weapons within a military alliance, as is the case with Turkey, Italy, the Netherlands and Belgium, and even in Germany where there is a comparably strong anti-nuclear popular feeling to Scotland.

18. On the liabilities side, the issue is whether Scotland should take a share of UK debt proportionate to population, or more, or less.

19. Prof. Rowthorn’s memorandum suggests that the starting position of Scotland might be to decline to take any on. However, it is equally plausible that the starting position of RUK would be that Scotland must take on more than its population share, on the grounds that the two biggest banks to have collapsed in 2008-9 were both Scottish. A letter from the First Minister to the then Sir Fred Goodwin has recently surfaced, in which the First Minister encourages the Royal Bank of Scotland’s then chief executive “for Scotland” to complete the merger with ABN-AMRO which led to the collapse of the bank. It is certain that this letter would form part of RUK’s bargaining position.

20. Both of these bargaining positions are probably unrealistic. It is likely, therefore, that the bargaining would converge on the position arrived at between the British and Irish in 1921 – again, in that case between countries that had recently been at war, one of which was considerably poorer than the other.

21. As noted by Prof. Rowthorn, Article 5 of the 1921 Treaty states: The Irish Free State shall assume liability for the service of the Public Debt of the United Kingdom as existing as the date hereof and towards the payment of War Pensions as existing at that date in such proportion as may be fair and equitable, having regard to any just claim on the part of Ireland by way of set-off or counter claim, the amount of such sums being determined in default of agreement by the arbitration of one or more independent persons being citizens of the British Empire.

22. The contingency of Orkney and/or Shetland having voted against independence would have no constitutional effect, but would strengthen the relative bargaining position of the RUK.

**Currency, monetary policy and central banking**

23. Scotland would have three options: to adopt the £ sterling, the euro, or create a new currency with a central bank (and, presumably, monetary policy committee) to support it.

24. The policy of the SNP was formerly to adopt the euro as soon as possible. Formally, the EU requires this, as well as acceptance of the Maastricht conditions on deficit and debt, as part of the *acquis communautaire* for a new member state. Scotland would probably be treated as a new member state for this purpose.

25. However, the SNP now states that it will retain the £ for the time being. The EU would be in no position to insist otherwise, even if the euro still exists at the time of Scottish accession.

26. If sterling continues to be used in Scotland, the Bank of England could only be required to take into account Scotland’s economic conditions in setting monetary policy if this were made a condition of the independence treaty in the post-referendum bargaining.
cannot see that Scotland would have any lever over the RUK to force it to make this a condition, therefore I assume that it will not be.

27. If this assumption is correct, then the RUK would retain an intense interest in financial regulation in Scotland. To avoid a “mini-Greece” scenario, the RUK might insist in the independence negotiations that the regime of financial regulation in Scotland must be cleared in advance by the Bank of England.

28. The only counter-threat available to Scotland in that case, that I can envisage, would be that Scotland would unilaterally adopt the £ sterling without specifically asking permission, as Ecuador and Argentina have done with the US dollar at times.

29. However, this counter-threat might alarm Standard Life, the Scottish Widows’ Fund, and Aberdeen Asset Management sufficiently that Scotland would be unlikely to use it.

30. For the same reason, I think that the pound Scots is not a realistic option. It would be more likely to depreciate than to appreciate against sterling in the first days and weeks. The history of the Czech and Slovak crowns immediately after the “velvet divorce” could be relevant here.

Fiscal policy and taxation

31. As stated in paragraph 5 above, the implications (in comparative statics terms) of the fiscal implications for RUK of Scottish independence are rather small. Two flows of roughly equal and opposite magnitude would cease. Tax income from the Scottish sector of the North Sea would cease to flow to RUK. Social protection transfers and Barnett consequentials from the UK Treasury would cease to flow to Scotland. The per capita implications are relatively serious for the average Scot, but relatively trivial for the average citizen of RUK.

32. A vote against independence from Orkney and Shetland does not change this much. In this I somewhat disagree with Prof. Rowthorn. I cannot envisage that the independence negotiations would result in an RUK including the Northern Isles: i.e., a country of two detached portions surrounding Scotland. The analogy of East and West Pakistan is not exact but sufficiently close to be worrying.

33. Rather, I expect that, as above, it would enable RUK to drive a harder bargain with Scotland on the price to be charged for the common services which the Scottish Government has signalled that it wishes to share: viz., head of state; overseas representation; perhaps military services; perhaps macroeconomic management and financial regulation.

34. In bygone days, such a payment was called an “imperial contribution”. It featured heavily in discussions and proposals for Irish Home Rule between 1886 and 1972 (for it nominally continued under that name in Northern Ireland until the abolition of Stormont in 1972). In the negotiations now envisaged, it would have a different name but the same function.

35. The effects of tax competition between Scotland and RUK would be relatively minor. Here, the biggest foreseeable risk surrounds Corporation Tax. Scottish politicians are
very tempted by the example of the Republic of Ireland, which for decades has attracted mobile industry with low corporation tax rates.

36. Should Scotland lower its corporation tax rate, there would be a deadweight loss as firms with operations both in Scotland and in RUK would immediately package their activities so as to maximise their taxable receipts in Scotland and minimise those in RUK. This would be pure deadweight loss from the perspective of the current UK.

37. Conversely, should Scotland raise its corporation tax rate, firms would do the opposite. Here there is an asymmetry, because any loss would mostly be borne by the Scottish taxpayer.

38. However, the fiscal prospect for an independent Scotland is poor, as Prof. Rowthorn’s work shows. It is important to note that his numbers mainly come from the official Scottish Government (and National Statistics) publication GERS (Government Expenditure and Revenue in Scotland). In the first years after independence, it would be difficult for the Scottish government to cut corporation tax rates.

39. Variation in VAT would lead to huge retail sheds going up in either Gretna Green or Carlisle. More importantly, it would lead online traders to “locate” in whichever part of the present UK offered them the most favourable tax regime. As with corporation tax, variation would lead to a deadweight loss. Amazon’s recent establishment of a base in Jersey for its online sales offers a case in point.

40. Variation in income tax, and its proxy, National Insurance, would have relatively little effect in the short term. Labour is less mobile than capital, and people choose where to live for many reasons among which relative tax burden is unlikely to be dominant.

41. The taxes where an independent Scotland would be least constrained would be those on the most immobile factor of production, viz., land. As an independent Scotland would inherit a truly dreadful basket of land taxes (Council Tax, Business Rates, and Stamp Duty Land Tax), it would have an excellent opportunity to pluck more feathers with less hissing than at present. But such moves towards tax efficiency would have few knock-on effects, because land is where it is.

42. The extreme volatility of North Sea Oil revenue poses a serious problem for Scotland but none for the RUK unless Scotland approaches fiscal collapse a la Greece. By assumption, the regulation of Scottish debt and deficit will have been discussed in the independence negotiations with RUK and with the EU. As negotiators will all be aware of the fiscal risk arising from a collapse in North Sea Oil revenue, they will have an incentive to design robust institutions.

22 June 2012
TUESDAY 18 DECEMBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Baroness Kingsmill
Lord Lawson of Blaby
Lord Lipsey
Lord McFall of Alcluith
Lord Shipley
Lord Skidelsky
Lord Smith of Clifton
Lord Tugendhat

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Examination of Witnesses

Rt Hon Michael Moore MP, Secretary of State for Scotland, and Mr Alun Evans, Director, Scotland Office.

Q901 The Chairman: Welcome, Secretary of State and Mr Evans. We are very grateful to you for coming. This is the 20th and final public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. I should just mention that I believe that we are being televised. I have said several times—but at this particular meeting I think it is important—that this Committee is dealing with the economic implications, as is right for our Committee, of possible Scottish independence and not with constitutional or political issues, in so far as they do not affect economic issues. It is purely on the economic issues. We felt in the run-up to the referendum that it was critical that voters understand the economic implications and issues, and that is what this Committee is about. Do you wish to make an opening statement or shall we go straight to questions?

Michael Moore MP: If I may, that would be very generous of you and allow me the opportunity, first, to thank the Committee for the thoroughness and the comprehensive nature in which you have been examining the themes and issues that arise out of this, at a
relatively early stage in this whole great debate. I look forward to the conclusions of the inquiry and the report that you compose at the end of it, and will look very carefully at the issues that come out of that and the recommendations that you make. In the context of all the other witnesses you have had, I am delighted to have an opportunity this afternoon, as you conclude your hearings, to share some of my own perspectives on this.

We as politicians are often accused of hyperbole and exaggeration, but if I were to claim that this is perhaps the biggest decision facing Scotland in 300 years you might be sympathetic to that idea. Certainly, it is one that we as the UK Government take incredibly seriously. That is why over the past 18 months, since the Scottish National Party secured its majority in the Scottish Parliament and got the mandate for a referendum, we have been very keen as a Government to appropriately and legitimately be part of the process. As you will be aware, a couple of months ago, the Prime Minister, myself and the First Minister and the Deputy First Minister of the Scottish Government signed the Edinburgh agreement, which aims to secure a legal and fair referendum and one that will provide us with a decisive outcome. That is one issue that is inherent in the economic aspects of this great debate. That process, which will transfer on a temporary basis the powers to hold a referendum to the Scottish Parliament, has been scrutinised and approved by the Scottish Parliament. It is still subject to the scrutiny of this House and the House of Commons. I hope that early in the new year there will be an opportunity for that scrutiny to take place. I make no presumptions about the outcome but hope obviously to secure support for that. As we deal with that important part of the process, we are also as a Government very much engaged in the substantive issues that are now at stake. I know that you had a session with Danny Alexander, the Chief Secretary, where he went into a lot of the technical detail around this. Obviously we will be covering some of those issues today. Danny has undertaken to get back to you on a number of issues. I hope that is happening. We will certainly make sure that it does and if there are any questions you put to me today that are beyond our technical know-how in the Scotland Office we will be happy to make sure you get the answers as well.

On the big, overarching issue about Scotland being an independent country and its economic position as an independent country, in the old days there was an argument saying that Scotland was too wee, too poor, too far away, and could not be independent. I personally do not accept that. I think we can be independent. We could be an independent country. The question for me—and I think this is true for people the length and breadth of Scotland—is: would that be better for us? Would we be more secure? Would we have greater economic opportunities? It is my firm view and the view of the Government that the answer to that is no and we are much better within the United Kingdom Government. We will not simply assert that, however, and as I announced in the other place a few months ago, we are undertaking a programme of work—the Chief Secretary referred to this in his evidence, the Scotland analysis programme—and from the beginning of this coming year we will produce what I hope will be a very useful series of papers that will set out some more of the detailed issues that are at stake, some of the basic facts and figures and analyses, to allow this debate to be as informed as possible. It is absolutely vital that whatever influences people’s votes, we will be doing this on the most informed basis possible.

On the merits of Scotland as an independent country, it is my strong view, frankly, that it is for the Scottish Government and the SNP to set out what they believe are the arguments for independence. Clearly, last week you had an opportunity to cross-examine the Finance Secretary on a number of issues where I know there were differences of opinion. We are fully engaged in that debate and as one of Scotland’s two Governments we are absolutely clear that we have to play a very strong role in that, but we are continuing to govern for the United Kingdom as a whole. We have made big, important announcements about decisions
affecting Scotland—whether it is the UK Green Investment Bank or the future of all our submarine fleets—that reflect that. But what we will not do is get into pre-negotiations. The Scottish Government can set out their process but we are not about to unpick the fabric of the United Kingdom when no decision has been taken to justify that. We have a responsibility to all of the UK and we take that very seriously indeed.

We are confident that we will prevail. However, we want to be clear about what would happen if there were a vote for independence. It is my view and the Government's view that that is the point at which negotiations would be triggered with what would then be the rest of the United Kingdom, as well as—again, your sessions last week in particular touched on this—the relationship with key international organisations such as the European Union, an issue that is fairly lively in the debate. We will engage in the debate but we will not pre-negotiate.

Finally, we hear from time to time members of the Scottish Government highlighting that paragraph 30 of the Edinburgh agreement is the answer to all the problems that might face them; it is the get out of jail card, some kind of magic lantern where the genie appears and they have three wishes to get rid of all the complex consequences of independence. I am confident that Members of the Committee have had the opportunity to read that paragraph. Essentially, I felt it was important that it was in the agreement because it commits us to work together in the spirit of the existing concordats and memoranda of understanding between the UK Government and the devolved Administration—that is the spirit in which we reached the agreement itself—and that we will respect the outcome of the vote. That is a really important statement up front. Afterwards we will act in the interests of the people of Scotland and of the rest of the United Kingdom. Yes, we will engage constructively and with a view to resolving difficulties between Scotland and the rest of the UK, but what we would not be doing is simply accepting that only Scotland's interests would apply in those circumstances; nor could we wish away the challenges there would be in Europe and elsewhere where other players, nothing to do with the rest of the UK, would also have a big stake in, for instance, the terms of European Union membership.

I apologise if that was slightly longer than you envisaged, Lord MacGregor, but I hope it is helpful in setting the scene of where we are currently in this process, and I look forward to your questions.

Q902 The Chairman: Thank you very much. We will be exploring these issues. I ought perhaps to have said at the beginning that normally we invite the appropriate Minister—that is, yourself—to come to our final session. We actually have one final session immediately after you have given evidence, with Sir John Gieve on banking and currency issues, because it was not possible to fit that in earlier. That means that we will probably have rather a longer session this afternoon.

Coming straight to one of the key issues, clearly the position of an independent Scotland in relation to the EU is critical. A lot of our witnesses have told us that, particularly those from the business community. Therefore, I would like to start with what has become a key issue in recent weeks, as you indicated, not least in the Scottish Parliament and the Scottish media. As you will know, in his letter to us, Mr Barroso said: “If part of the territory of a member state would cease to be part of that state because it were to become a new independent state, the treaties would no longer apply to that territory”. Mr Swinney’s point on this was that he disagrees because there is no foundation in the treaty for that position to be supported. What is your understanding of that issue, and what contacts have you had with the European Commission in this context?
Michael Moore MP: Our view is that President Barroso’s observations were not surprising to us. They are entirely consistent with the Government’s view that the most likely scenario is that the rest of the United Kingdom would continue as the member state and that Scotland would have to apply and negotiate the terms of membership. We welcome the contribution made by President Barroso, which is entirely in keeping with the overwhelming weight of academic and international opinion and international precedent. As for contact with the Commission, we have not gone directly to the Commission. We have not seen the need to do that. We have looked at the broad range of evidence that is in the public domain already. But it was helpful that in response to your inquiries as a Committee we have that further confirmation.

The Chairman: So you absolutely disagree with the point that Mr Swinney was making?

Michael Moore MP: I think he is fundamentally wrong. I think we have seen over the past nine months a shift from a position where the First Minister could say, in effect, that it was not a problem; Scotland’s membership would be automatic and the terms and conditions would fly on as before. We have seen in the aftermath of the Edinburgh agreement and in the weeks since, first, a recognition that they had not actually been taking very serious soundings on that in terms of advice. Further to that, they have now had to concede—as indeed John Swinney did last week with you—that the terms of membership would have to be negotiated. That is the fundamental issue. One can argue whether or not the membership is automatic and transfers. That is important and it will be a time-consuming process even with the best will in the world and a strong wind, but the terms of that membership will be fundamental in terms of the opt-outs that the UK has and in the interests of Scotland’s economy. I am glad we have got that acknowledgement from the Scottish Government now. Perhaps we will see that flow through into some of their other arguments as well.

The Chairman: To be absolutely clear, if the referendum result was a yes, the Scottish Government would have to start negotiating as a new member state.

Michael Moore MP: Correct. It is our view that that is the most likely scenario based on all the evidence and precedents elsewhere.

Q903 The Chairman: Following on from that, you referred to the papers that you are producing before the referendum. Mr Swinney said—in the context of negotiations with the EU—“We have always made it clear that there would have to be a process of negotiation and transition that followed that decision in principle by people in Scotland that they wished to proceed to independence. In that window between a decision on the referendum in the autumn of 2014 and the establishment of an independent country … there is the opportunity to essentially resolve that particular question”—which is the question of what the terms of entry would be. Given that this is so crucial, and there are various other aspects, which we will be coming on to, that are so important, and we think it is important that in the referendum everyone should be aware of what these terms and negotiations are, if the first referendum was for yes, do you think it would be necessary to have a second referendum once the terms are actually clear?

Michael Moore MP: There are a number of different debates to be had around this issue. I have been party to some of them myself. As we considered this carefully within Government—and I have to say that on this issue, there was a meeting of minds with the Scottish Government—our determination was to ensure that we have a decisive referendum. The principle of separation will be established, one way or the other, by the referendum in 2014. That means that people will do it with the uncertainty of knowing what
the terms of that separation will look like, although we wish to ensure that we resolve as many areas of uncertainty to do with what an independent state looks like and what issues would have to be resolved, so that people understand what is at stake. The two Governments, on the back of a yes vote—however unlikely that is—would then have to negotiate. We do not have a mandate as a Government. I am a Scot representing a Scottish constituency in the United Kingdom Parliament. We do not have a mandate to go off and start negotiating those terms and conditions. I do not believe that should be done.

The Chairman: But if there was a yes vote and then some of the terms of the negotiation into the EU are very onerous for the people and economy of Scotland, and some of the other issues in relation to the Bank of England and so on, which we will be coming on to, that means that there is a sort of blind vote in the first referendum and then people would have to wake up to some of the consequences once they negotiated.

Michael Moore MP: There is a huge amount at stake here. I am not going to play that down. But I do not see how you can have a process beyond that if you do not accept that the decision in 2014 is decisive. If you want it to be other than decisive, that is a different type of process that you would undertake. To my mind, it will absolutely concentrate the debate on what is at stake, and what the uncertainties are. I am not going to play down those uncertainties. Indeed, it is the Scottish Government’s unwillingness to acknowledge uncertainty that has hampered the debate in the past 18 months. My view is that the fog on that particular issue is lifting. They are more willing to accept, I hope, that there is uncertainty and that, therefore, there is a lot at stake. I think people in Scotland need to understand that.

Q904 Lord Forsyth of Drumlean: You said that you wanted the debate to be as informed as possible. One of the things that Mr Swinney said to us last week was that they had a difficulty in establishing what the position would be vis-à-vis having to apply for membership of Europe or whether they would be allowed to remain in Europe because the Commission would only talk to Governments, and that the British Government were not prepared to engage on this issue. I find it a bit puzzling how you can reconcile saying, “We are not prepared to talk to the Commission as a Government about what the consequences would be”, with saying at the same time, “We want to have a fully informed debate”. Does Mr Swinney not have a point there?

As another example, we asked Defence Ministers to come and give evidence to us on the consequences of the nationalists’ policy of wanting Scotland to be a nuclear-free zone, with the loss of jobs that would occur at Faslane and Coulport and the possible consequences for the British independent deterrent. The view from the MoD was, “We are not thinking about what plan B should be or what the consequences should be because we do not think it is going to happen”. I live in Scotland. You live in Scotland. I want to know what the consequences of a vote in this referendum will be for the defence of the United Kingdom and also for our membership of the European Union. The British Government appear to be taking the position of not accepting that this has happened until it has happened, which must by definition mean that we do not have an informed debate.

Michael Moore MP: I respect the line of argument while not agreeing with it. Perhaps we can agree on this much: there will be elements of this that are, to put it mildly, inelegant in terms of how well informed people can be at the time of that vote. Short of doing those pre-negotiations, which as the UK Government I do not think it is our place to do, I believe we cannot resolve some of those issues. Dealing with the European Commission position, the Scottish Government have said they will wish to talk to President Barroso because they
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think he is wrong in his interpretation of the treaties and the reality of future membership. President Barroso has made it clear that he is setting out his view of the interpretation of those treaties as he sees it. It absolutely conforms with the UK Government’s view on that and we will, in greater detail, set out more of these arguments in the course of the next year.

Lord Forsyth of Drumlean: So you will talk to the Commission as the UK Government?

Michael Moore MP: This is not the final word on the subject from the UK Government; we are just setting out what we are confident is the position and we will set out our more detailed arguments in support of that over the course of the next year. We do not believe it is necessary to talk to the European Commission on this, nor would it be appropriate for us to do it with a view to having some kind of shadow negotiations when all the other many complex aspects of this process would not be known. It is not for us as the United Kingdom Government to argue over the opt-out on the single currency, on Schengen, on all the various different matters that matter so much to the Scottish economy. I accept that that creates an uncertainty but it is not an uncertainty of our making; it is an uncertainty of the Scottish Government and the SNP’s making.

Q905 Baroness Kingsmill: In your opening remarks, you said that one of the considerations was whether or not Scotland would be better off in the event of independence and that in your view it would not. The focus of this inquiry is what are the economic consequences for the United Kingdom of Scottish independence, not what are the consequences for Scotland. It is slightly irresponsible of the Government not to focus in advance of a referendum on what those economic consequences might be. I am astonished by your remarks that there will be no negotiations, discussions or exploration of these economic consequences for the United Kingdom. If I have perhaps misinterpreted your remarks, I would be grateful if you wanted to expand a little further on them.

Michael Moore MP: We take the situation of the United Kingdom economy phenomenally seriously. It is, rightly, the major preoccupation of the Government as we go about our daily business. As Scottish Secretary, alongside my constituency responsibilities, along with all my Cabinet colleagues, I am very focused on that. I want to maintain the United Kingdom because I think it has great benefits to my constituents and to people across the whole of the country. I regret the uncertainty but the reality is that we are not in a position where we can create a hypothetical set of circumstances to understand what the negotiations would be. We do not have a position within Government that separates out Scottish interests from the interests of the rest of the United Kingdom. We are all collectively responsible for the governance of the whole of the United Kingdom. As I said in my opening remarks, I do not believe it is right or appropriate for us to unpick the fabric of the United Kingdom on a hypothetical, notional business ahead of negotiations that can only properly be triggered by a vote for Scotland to become independent.

Baroness Kingsmill: I have to say, Secretary of State, that that seems a rather weak answer. Most corporates, when faced with a decision of this kind, would do some scenario-planning and risk management, and have some idea of what the consequences would be for the larger part of the United Kingdom. I am surprised by your answer.

Michael Moore MP: It may not allay your fears, but again I point to this famous paragraph 30, which in essence says that once we have the result of the referendum, whichever way it goes, both Governments will respect the fact that they will be negotiating for the interests of Scotland and the rest of the United Kingdom. That will be a point where the rest of the UK
will be able to work through what it believes are the important interests that have to be resolved and the terms on which it wishes to negotiate those terms. It is not a position where people will be bounced into a particular set of outcomes without any prior thought. There is space there. We in Scotland have to respect that the rest of the United Kingdom will have its interests at stake at that time and is not simply going to offer Scotland a free pass on all of this. That is a reality of this process that we need to acknowledge.

**The Chairman:** But once that happens and the outcome, for example, is very unfavourable to Scotland or to the rest of the United Kingdom, what happens next? Presumably Scotland becomes independent on unfavourable terms, or very favourable terms, or whatever, but there is no referendum to take a final decision.

**Michael Moore MP:** But, if I may say so, and this is part of the reason we worked through this in advance of the approach we took to get a decisive referendum, you would then end up in a position where Scotland had a referendum on the principle; the detail then had to come back to it; how the rest of the United Kingdom determined its satisfaction with those terms and conditions here in Parliament or elsewhere is yet to be resolved; and we could end up with Scotland voting yes one time and no the next time. We would get into a terrible cycle where the rest of the United Kingdom—dare I say it?—was in huge uncertainty as whether or not Scotland was coming or going. As I say, this is inelegant—if I may borrow a recent phrase, “It could be messy”—but it is the real world of politics and different sets of interests will have to be resolved. We are committed to doing that constructively. We believe that is the right way to do it and we will respect the outcome, but it cannot be an outcome that is conditional on lots of further referenda that determine whether they are the right terms or not.

**Q906 Lord Tugendhat:** You talk about the “real world of politics”, Secretary of State. In the real world of politics, Governments have a duty to undertake contingency planning. Of course I understand your point about not wishing to “unpick the fabric of the United Kingdom” on the basis of a hypothetical situation but I would not believe you if you were to tell me that no contingency planning is taking place in Whitehall about the possibility of the euro breaking up. We may well hope that the euro continues but if you were to tell me that the Treasury had not considered the possibility of the eurozone breaking up, I would not believe you. I find it very hard to believe that the Ministry of Defence has undertaken no contingency planning as to what will happen to our Armed Forces in the event of Scottish independence. At any one time, the MoD is doing contingency plans on all kinds of variables and hypothetical situations all over the world. If we are looking into what might or might not happen if the eurozone were to break up, then surely to God we are looking into what might or might not happen if the United Kingdom were to break up. If we are not, it is a dereliction of duty.

**Michael Moore MP:** Perhaps I might make a distinction, and what I hope is an important generic point about government behaviour, entirely in keeping with what you say about contingency planning and looking forward at uncertainties. There are many highly experienced former Cabinet Ministers here this afternoon and others with great experience of corporates and public life. I would make a distinction between contingency planning about unknowns, things that can be foisted upon you at an unknown time—the eurozone might be an example of that—and here, where we have a defining moment. We will know the date before too long. We know already it is going to be autumn 2014. That is the moment that will crystallise the ability to work through all the different issues.
I do not want to leave anyone on the Committee or anyone in the debate inside or outside Scotland with the notion that we as a Government are not taking seriously all the different issues. We want to ensure that they are all laid out properly. On defence, we want to highlight not only that Scotland is the home of the independent nuclear deterrent but is on track to host the UK’s sole submarine base at Faslane. Equally, we want to point out that our military is so well integrated across the country that, as the Defence Secretary said at one point, it is not like a bar of chocolate where you can break a piece off and have a “Scottish Defence Force” and there are no consequences elsewhere. There are all sorts of central intelligence, logistics and other support things that are unevenly spread around the United Kingdom. All that would have to be worked through. I will not suggest for a minute that there are not consequences to that, but there are consequences that we will manage and would have to manage in the most appropriate and secure way, triggered from a point. That is why how long it then takes to resolve those issues and work them through is as much a matter of the rest of the United Kingdom’s interests as it is of the Scottish Government and the Scottish people’s interests. Therefore, I think that is qualitatively a different type of issue.

Q907 Lord Lawson of Blaby: May I suggest, Secretary of State, that your position is totally unsustainable? Leaving aside for the sake of simplicity the people of the rest of the United Kingdom, I think you are letting down very badly the people of Scotland. You said in your opening remarks that Scotland is perfectly capable of being an independent nation. I agree entirely. It is a very fine country, perfectly capable of being independent. There are many independent countries in the world that have less going for them than Scotland. But you said that the important issue is the net consequences of independence—would they be favourable or unfavourable to the people of Scotland? How are the people of Scotland to judge this if you are not prepared to say what in your considered judgment the consequences will be? That seems to be a totally unsustainable position.

You talked about the “real world of politics”. You are in the real world of politics and you are accustomed to general elections. The consequences of general elections are not nearly as momentous as will be the consequences of this referendum if it were to go for separation. Even in a general election, you would not let the other side in the debate make all the arguments about what the consequences of a particular choice would be and make no arguments yourself. You would not dream of doing that, yet this is the position you are taking up in the light of the Scottish referendum. I believe that to be completely unsustainable and I hope you will rethink.

Michael Moore MP: I acknowledge the strength of your contribution, but please let me make a distinction between pre-negotiating the outcome and saying, “Here is the determined outcome”, which means we have to work through and spend the next 18 months having a shadow negotiation with the Scottish Government about its proposals on the Bank of England Monetary Policy Committee and the like on the one hand, and what you do with the Armed Forces on the other—which I just do not think we have got a locus or a responsibility to do because our responsibility is to continue to govern for the whole of the United Kingdom—and setting out the details of the issues, much like this Committee has highlighted already this afternoon and you have discussed in all your previous evidence sessions and no doubt will feature strongly in your report about the issues that are at stake.

I think you are entirely right to be pointing out all these different issues. The papers that we will publish as part of the Scotland analysis programme will set out those issues; they will highlight the strengths and the issues around the integrated United Kingdom economy and
how it matters to organisations like a company in my own constituency that manufactures coat hangers: 95% of its market is south of the M62; England is very important to that company. The issue we will put to that company is: you are part of an integrated economy at the present time. If we separate, over time there will be issues that will mean that Scotland and England will diverge. I believe that is not in our best interests. We have got strength in what we have. We will highlight all those different types of arguments. What we are not doing is pre-negotiating, but what we are doing and what we fully intend to do is set out the detail of the arguments and the analyses that back that up.

**Q908 Lord Shipley:** To be really clear about the knowledge that a voter will have prior to casting that vote in a referendum, you will have laid out the issues properly and they will be shared with those voters in advance, and others will lay out issues as they see them as well. Are you confident that a voter in Scotland will have the knowledge needed to cast a vote in the referendum, which will not cause them to say, in the period afterwards when there is a negotiation, “Well, if I had known that, I would never have voted yes” or “I would never have voted no”? Are they able to make a choice because they have the information that enables them to make that choice and then not regret it?

**Michael Moore MP:** I am not sure I am qualified to speak for this hypothetical voter. Of course people can take a view subsequent to elections about whether or not they voted the right way. That is the essence of elections and politics; we all live or die by that. In terms of our best intentions, we want to have a fully informed and robust debate. That means setting out all the different angles about the economy, which is one of the fundamental areas. We want the analyses and arguments that we present to be open to scrutiny—by your Lordships but also by independent academics and think-tanks, and the people in Scotland—and we will scrutinise what is put forward by the other side of the argument as well. It is our duty to make it as well informed a debate as possible. We will distinguish between what are from my perspective the very strong reasons for maintaining the UK, the benefits we get from being part of the United Kingdom; the areas where there will be uncertainty, where we cannot know the outcome until the post-referendum negotiations; and areas that are always open to review five, 10 or 20 years down the line.

**Q909 Lord Lawson of Blaby:** You also mentioned in your opening statement the Edinburgh agreement, to which you were a signatory, particularly paragraph 30. Paragraph 30 in its general shape is very sensible. It suggests that if there were to be a divorce, it would be an amicable divorce; to continue the metaphor, the countries would remain on speaking terms with each other and would be friendly and co-operative towards each other. However, when he appeared before us last week, Mr Swinney went much further than that. He said specifically, so far as we could understand it, that under the terms of paragraph 30 of the Edinburgh agreement, which obviously you know all about, if sterling were to be the currency of choice for an independent Scotland, the Bank of England would continue to be the central bank for Scotland. Is that your interpretation? That seems bizarre. I have had some dealings with the Bank of England in the past. But that is what he said. Is he right?

**The Chairman:** I am sorry, I am going to have to leave you time to think about that question. We have got a Division. We will be back as quickly as we can.

*Sitting suspended for a Division.*

**Q910 The Chairman:** I think we can resume. Lord Forsyth?

**Lord Lawson of Blaby:** I am waiting for an answer.
The Chairman: I beg your pardon. I gave you plenty of time to think about the answer and then forgot about it.

Lord Lawson of Blaby: I have waited a long time for it.

Michael Moore MP: I hope it is worth it. The answer to your question is simple. Paragraph 30 does not cover that. It does not make commitments that the United Kingdom will simply unilaterally accept every last assertion or expectation of the Scottish Government. It is particularly hard, even if you were minded to do such thing, in a situation where they have not spelt out exactly how they think that would work. No, paragraph 30 does not give them a free pass to all their policy wishes.

Lord Lawson of Blaby: But I asked a very specific question, not whether paragraph 30 gives them the answer to all their policy wishes. Their original idea of the euro does not look so good now so they have said that they would use sterling as a currency. Mr Swinney said the clear implication of paragraph 30 of the Edinburgh agreement was that in that event the Bank of England would be the central bank of an independent Scotland. Is that right—yes or no?

Michael Moore MP: No. If they chose to seek to negotiate such a situation in the aftermath of independence, that would be a different matter, but the idea that somewhere under here there is a magic paragraph that only the SNP can see that says all these things will be sorted, that is completely wrong.

Q911 Lord Forsyth of Drumlean: Following on from this issue of the role of the Bank of England, the Scottish Government have been telling everyone who cares to listen—I think Ms Lamont put it rather neatly when she said that everything will change but everything will remain the same—that as far as the Bank of England is concerned, it will remain as the lender of last resort, which is clearly of key importance for financial institutions. We have asked the Bank of England if it would care to give us evidence. Understandably, the Bank wants to keep out of political debate. Last week, Mr Swinney told us that the Scottish Government had had discussions with the Bank of England, which was subsequently denied by the Bank of England, which said that it had responded to specific questions. So we are really relying on the Government to spell out what the position would be with the Bank of England. You have just answered Lord Lawson by saying, “Well, that is something that will be negotiated after the event”. What conceivable reason would taxpayers in what would be the rest of the United Kingdom after Scotland had become independent want to be lenders of last resort to a foreign country; that is, Scotland? If you cannot think of a reason, why are the Government not making it clear to people that there will not be a lender of last resort and the consequences that that will have for financial institutions and for stability, given the dependency on oil revenues of the Scottish economy?

Michael Moore MP: I agree with you that the rest of the United Kingdom would have serious doubts over wanting to provide the lender of last resort facility. We are not the ones making the case for that being the situation after independence. What we do not have is a proposition from the Scottish Government. We have the Bank of England with responsibility for the whole of the United Kingdom, as things stand. We are invited to speculate that there would be some form of territorial representation on the MPC, which is quite out of keeping with its primary purpose and the way it is convened at present. Whether or not that was feasible, whether or not the rest of the UK regarded that as appropriate, whether or not that could be negotiated, you would have to ask yourself whether that was sufficient for the Scottish economy in the generous spirit in which the rest
of the UK had allowed it to happen. I am clearly not persuaded that would work or is desirable. The Scottish Government should set out its detail. In our Scotland analysis programme we will set out what we believe are the arguments around that and why we think this is an easy way for the Scottish Government to try to pretend that all the difficult issues after independence will have been resolved. One might be entitled to ask, if you are keeping the currency, if you are hoping to keep the Bank of England and UK financial regulation, what kind of independence is this? But that is obviously for another day.

Lord Forsyth of Drumlean: Your answer is not clear to me. If we were on one of these panels or debates, which have been set up in Scotland, on the merits and consequences of independence and those who wished to break up the United Kingdom are saying, “It will be fine. The Bank of England will still be there as the lender of last resort. We will have a place on the Monetary Policy Committee”, do we have the authority and the backing of the Government to say, “No, that is not going to be the case. There will not be a lender of last resort”? What you are saying is that there might be a negotiation afterwards and you will have to wait and see.

Michael Moore MP: No. Perhaps I was being too generous to the Scottish Government. Our starting point is that the rest of the United Kingdom would keep the Bank of England and that would be for the rest of the United Kingdom’s economy. The Scottish Government need to stop pretending that is somehow in the bag, that we have agreed. We have certainly not agreed to that. It would take an enormous amount of persuasion for the rest of the United Kingdom to come to that conclusion. In the papers and analyses that we will put out over the next few months, we will be setting out the basis of those arguments very clearly so that you, me or anyone else on panels up and down the length of Scotland, or talking to folk in the high streets around the country, we can answer these questions very clearly.

Lord Forsyth of Drumlean: So your paper will say, absolutely, there is no question of the Bank of England being the lender of last resort or of the Scots having any representation on the Bank of England, and there will have to be some kind of stability pact to control the spending and borrowing of the Scottish Government if you are going to use the currency—is that what it will say?

Michael Moore MP: If I may not pre-empt the careful work that my colleagues in the Treasury are working through at the moment, our starting point will of course be that the Bank of England is for the rest of the United Kingdom. It is governed by legislation of this Parliament, not of the Scottish Parliament.

Lord Forsyth of Drumlean: When will they have finished their careful work?

Michael Moore MP: The work will be set out in the early part of next year, I hope, in very good time for all this debate to be worked through and for your Lordships to be able to re-examine the issue as appropriate.

Alun Evans: I was just going to add that the paper on currency and monetary policy is likely to be one of the earlier ones coming out, so it should be out in the first half, easily, of next year.

Lord Forsyth of Drumlean: He said the early part of next year; you are saying the first half.

Michael Moore MP: If you will allow us a little latitude, Lord Forsyth. Alun is perhaps being slightly more cautious, in a Civil Service way. But we want to do this as soon as possible.
You are right to focus on this as a key issue of interest, not just to Scotland but the rest of the United Kingdom. We are urgently on that task.

Q912 Baroness Kingsmill: Secretary of State, you have modified your position somewhat since my opening question, where you gave us all the impression that you were going to go into this referendum unsighted. But you are suggesting that this Scotland analysis programme you are discussing is in fact going to make it clear to everyone what the position of the rest of the UK’s Government is in relation to the economic issues in particular that the UK would be facing in the event of Scottish independence. Then you went on to say that there would be subsequent negotiations on various issues but you would have set out in advance what your position was and then you would enter into the negotiations. In the event of a yes vote, how long do you think these negotiations would continue?

Michael Moore MP: I apologise to you and the rest of the Committee if you regard that as a shift. I am very happy to draw the distinction with regard to the important work we are going to do through the Scotland analysis programme, which will set out all the detail of these arguments—what the United Kingdom provides across the country for Scotland and the rest of the UK, and therefore what is at stake. It is a straightforward logical conclusion that after separation, Scotland loses its place in all these great institutions in the United Kingdom unless it wishes to negotiate its way back in, and the attitude of the rest of the UK to that is something that cannot be known in advance but, as Lord Forsyth highlights, you can have a fairly decent stab at it. We look forward to some robust involvement in those discussions by the Scottish Government, and not simply the assertions we have had.

To your point about how long this takes, I cannot offer an answer. How long do international negotiations take? How long will this take? We are an integrated United Kingdom that has existed for 300 years. We have many things that distinguish the nations within it but we have, through our economy, our defence arrangements and, as the Americans might put it, homeland security, and so much else, a highly integrated state—devolution notwithstanding. That will take time to work through.

Baroness Kingsmill: Indeed it will and, given what appears to be your level of preparedness at the moment, it seems it could take some considerable time. Some people are talking about two to five years. If it does take that length of time, and on the assumption that there is a yes vote, is it not then going to have the effect in terms of the uncertainty of the equivalent of a no vote? It is going to have a lot of adverse consequences. I can imagine that corporates, for example, would not wish to take investment decisions that would be influenced by where they were going to put their headquarters or whatever because of this uncertainty. Do you not think that it would be extremely damaging to the economy—possibly to both economies—if there were a long period of negotiation post a referendum vote?

Michael Moore MP: Uncertainty is damaging for all businesses. It is damaging for all economies. As I say, it is not my choice or desire that we should have this referendum but there is a mandate secured by the Scottish National Party to do it; we must live with the consequences of that. Let me be clear: we as the UK Government are not just talking about what is at stake but these analysis papers will set out what the strengths are for the whole of the UK for having Scotland as part of it and for Scotland being part of the UK. We will also, by the actions that we are taking, be demonstrating to investors and corporates—and I talk to senior business figures in Scotland or, as I did last week, in north America as well—in a way that shows a) that we are making the right arguments; b) that we are putting our own money where our mouth is, in terms of our confidence about Scotland’s continued place in
the United Kingdom; and c) that Scotland remains a very good place to invest, and I want that to remain the case throughout this process.

**Q913 Lord Skidelsky:** Witnesses expect an independent Scotland to obtain a geographic share of North Sea tax revenues but to lose transfer payments from the Barnett formula. They argue that, as things stand, they will broadly cancel each other out. What is the Government’s view on that? Given the fact that, as some experts believe, Barnett transfers are more predictable than oil revenues, what do you think would be the effect on the UK economy of a weakening of the Scottish economy as a result of the sources of its revenue drying up?

**Michael Moore MP:** The issue of the United Kingdom’s natural resources and Scotland’s share of those is, again, a big area for debate and argument. Again, we can establish—the Scottish Government do this every year with some of their reports—per capita allocations or geographic allocations of oil and gas revenues. Again, that would be an issue for negotiation after the event, but even on the most positive outcome from a Scottish perspective, one can see that those revenues are volatile, and we have a finite set of natural resources. I pay tribute to the oil and gas sector for its amazing ingenuity over many decades, which has extended the lives of North Sea oil and gas, and developed fields west of Shetland and elsewhere. We can continue to develop that and be as creative as possible but I think everyone has to accept that there is volatility in the price; there is sometimes volatility in the production, and I think you make an important central point that with the funding allocations within the existing UK state, there is a degree of predictability, which is in the interests of Scotland and the rest of the United Kingdom. One can work that through. It has been one of the underpinnings of devolution—quite different from independence—that the Scottish Parliament and by extension the Scottish Government have been able to look ahead with some confidence at the revenues they will have.

**Lord Skidelsky:** Yes. It is clear that there will be negotiation about revenue-sharing from oil but the Government will make it clear that the Barnett subsidy will stop?

**Michael Moore MP:** Without question, an independent Scotland will have to raise its own taxes in Scotland—end of story.

**Lord Skidelsky:** No wriggle room there?

**Michael Moore MP:** Your question helps to crystallise the difference between independence and devolution. Independence is about a separate state, raising its own revenues, determining all its expenditures and having to live with the consequences, whether that is a good or bad thing. If somebody suggested that there would be ongoing United Kingdom Treasury-sourced funding for an independent Scotland, one would ask whether that was really independence and I am sure that people in the rest of the United Kingdom might have something to say about that. In fairness, I have not heard even some of the more optimistic members of the Scottish National Party make that case.

**The Chairman:** Some of the same arguments might apply to the question of the Bank of England acting as lender of last resort.

**Michael Moore MP:** For the reasons that I have already set out in response to Lord Forsyth, I think it is highly unlikely that that would be acceptable position for the rest of the United Kingdom. It is the habit of the Scottish Government and the Scottish National Party simply to assert that that will happen. The whole of the rest of the United Kingdom would have to be extraordinarily generous both in spirit and intent to take that on. I am not
saying that is beyond the rest of the United Kingdom but one would have to ask why that would be sensible or why it would be done.

**Alun Evans** : The other point, may I say, in response to Lord Skidelsky’s point about oil and gas revenues is that at the moment oil and gas revenues are only about 1% to 2% of UK revenue. If Scotland were independent, they would be 16% to 20% of Scottish revenue. Much greater volatility obviously causes more difficulty in absorbing that.

**Q914 Lord Shipley**: Secretary of State, will one of your issues papers be on the subject of defence? Do you have any estimate of the economic value of UK defence assets in Scotland? Very specifically, we have heard from other witnesses that an independent Scotland’s defence sector could shrink rapidly following independence, largely because the rest of the UK would place defence orders at home rather than in Scotland.

**Michael Moore MP** : The defence sector is hugely important in Scotland, both in terms of the presence of the Armed Forces and because of the defence industry itself. I will lay out some of the figures for the Committee. As an integral part of the United Kingdom, we have 15,000 MoD personnel in Scotland: 11,000 regular Armed Forces and more than 4,000 civilian personnel. There are also approximately 3,000 volunteer reserves and 17,000 cadets. The UK defence budget is £34 billion, the fourth largest defence budget in the world; in addition, there are all the different intelligence budgets, which amount to roughly £2 billion. That scale allows us to invest for the whole of the UK’s defence in some of the most sophisticated defence equipment and systems we could hope for. Many of the MoD’s prime contractors are based north of the border, including BAE Systems, Raytheon, Rolls-Royce, SELEX Galileo, Thales and Babcock Marine. It is a huge industry for Scotland: more than 12,000 people and annual sales of £1.5 billion. When you look at individual projects like the Queen Elizabeth class carriers, there is £1.3 billion and 4,000 jobs directly linked to the programme. These are hugely important for Scotland and the United Kingdom, but there is also an asymmetry. We have capability in Scotland, whether it is in defence industries or the actual military footprint, which is not replicated elsewhere in the UK. It is a big area of work that will be important economically as well as in defence terms. But we will have a paper and that will set out all these details for your and other people’s consideration.

**Lord Shipley**: Will it address the issue that there might be a rapid shrinking of the defence industries in Scotland?

**Michael Moore MP** : Again, in evidence to Committees in the House of Commons, Defence Ministers have set out what has been the practice. There are exemptions from competition rules that allow national Governments to place orders for big military projects in their home territories that would otherwise, if they were a different type of commercial operation, have to be open to competition. Anyone who has been to Govan or Scotstoun and seen the Type 45 destroyers or the Queen Elizabeth carriers being built, or seen the amazing project being assembled on the Forth at Rosyth, can appreciate the sheer scale of what Scotland might turn its back on. I am not suggesting that another series of aircraft carrier proposals will be coming along any time soon, but Scotland contributes a huge amount in shipbuilding and elsewhere. The Raytheon facility in Fife recently secured a big contract from the MoD, again for a UK-wide capability.

**Q915 Lord Lipsey**: The SNP predicts that independence would be followed by a great unleashing of Scottish entrepreneurial energy and initiative. Is that a subject that one of your papers will address, and from what you have seen of the evidence so far, do you think that is a likely outcome?
Michael Moore MP: Scotland has a fantastic tradition of entrepreneurs, as have other parts of the United Kingdom. There are many who grace the Scottish economy at present. There are many efforts taken by the Scottish Government under its existing powers to encourage that further. There are lots of great businesses that support one another in their efforts to encourage the next generation of entrepreneurs. I personally think that that wealth creation is absolutely fundamental to us. We can be proud of our track record. We can be confident that we can continue to develop new entrepreneurs. Have we ever got as many as we should have? I do not think so. I think we need to do more of that. I wait to see the arguments that suggest that entrepreneurship will be more obviously encouraged by Scotland being independent. In the UK it is one of our main objectives at the moment to encourage more entrepreneurs, through our reforms to the tax system and what we are doing to encourage people to invest in entrepreneurs’ projects or to go into business by reducing corporation tax. We can do all that on the scale of the United Kingdom and on the basis that it is not specific to where you come from. I do not believe that independence is the key to unlocking any additional entrepreneurial flair; we should do more about it at the present time.

Lord Lipsey: I did ask whether you are planning a paper specifically on this topic as part of the series you are producing.

Michael Moore MP: Apologies. Not a specific paper as such but we will clearly look at all the different aspects of the economy and I take note of the Committee’s interest in this particular issue.

Q916 The Chairman: Secretary of State, we have had a long session. Are there any other issues that we have not raised that you would like to put to the Committee?

Michael Moore MP: I appreciate that it has been a compressed session. My sense is that there are lots of other areas that we might explore. I would like to simply reiterate my thanks for the opportunity to be here this afternoon and for the work that the Committee has been doing. I recognise that there are a range of issues that you want to look at further. I appreciate that until you have seen the papers from the analysis programme you will reserve judgment, but that is a serious programme of work. It will come in the public domain from the early part of next year and I look forward to your further scrutiny of those papers and other contributions you will make to the debate.

Lord Forsyth of Drumlean: Perhaps I can just ask a quick question that flows from the Secretary of State’s opening remarks. You pointed out that both Houses of Parliament would have an opportunity to scrutinise the Section 30 order when it comes before Parliament. I think it comes before this House on 16 January. Would it not have been better for us to be able to scrutinise it once we knew the question and the date of the referendum, and the rules pertaining to the referendum? Otherwise there is not really a lot to scrutinise, is there?

Michael Moore MP: I am aware of the Motion that you have placed for debate alongside the Section 30 order. I do not wish to prejudge the debate and the arguments that you will make in the course of that, Lord Forsyth. Let me put it this way: we set out a very clear objective when we published the consultation last January that we wished to secure a legal, fair and decisive referendum, and that we wish to do that by devolving power to the Scottish Parliament because fundamentally, in the spirit of devolution, to which I am personally very committed, it was important that this was a referendum made in Scotland. I believe that with the terms of the Section 30 order, which make this a single question on independence, with
only one referendum on that day, before the end of 2014, we secure the legal aspects of this and make sure that we get the decisive outcome. I believe that the Edinburgh agreement, sitting alongside the Section 30 order, commits both Governments to a proper process where the Electoral Commission plays its usual and proper role in assessing the question and the rules of the referendum, and setting such things as the campaign finance limits. That is the right way forward and the right balance. It can give the country the confidence that this will be a fair referendum and it will give us the certainty that we will have a decisive outcome.

Q917 The Chairman: Secretary of State, you have acknowledged that this Committee has been doing a great deal of work looking at all the issues pertaining to potential Scottish independence, from the point of view of both Scotland and the rest of the United Kingdom. As a result of all the evidence, we have been coming to conclusions about huge numbers of areas where there are still great uncertainties. We are also very concerned that, despite all the papers that will come forward, there are issues for negotiation after a vote, if it is a positive vote, which are absolutely critical for the outcome for both Scotland and the rest of the United Kingdom. It would be helpful if you could give us a note listing the papers that are about to be published next year, and the timetable. We have asked the same of the Chief Secretary and he has offered to try to help us. It would be helpful if you could give us a note so that we have some understanding of when all these issues will be put forward from the UK Government’s point of view. I hope we may be able to return to these issues once we have seen them. Meanwhile, thank you very much indeed for giving evidence to us this afternoon.

Michael Moore MP: Thank you for the opportunity. Implicitly I was saying yes, you will get a note. It is important for Parliament and for the public debate that people will know when these papers are going to be published in the appropriate way, and as soon as is appropriate we will make sure that happens.

The Chairman: I hope it will reach us before we actually publish our report. Thank you very much.
The Chairman: Mr Miller, good afternoon. This is one of the two remaining sessions of our visit to Scotland. We have included farmers and the Scottish NFU because farming is not an area that we have covered very much in our inquiries so far. However, we recognise the importance for you and for the Scottish farming community of these decisions, so I am very grateful that you have come, and I am very glad that we are having this session. I do not know whether you want to make an opening statement. It may help you to know that the first question I am going to ask almost involves an opening statement, so perhaps we should go straight ahead. What is the general view of Scottish farmers on the prospect that Scotland might become an independent country?

Nigel Miller: Firstly, thank you very much for the opportunity to speak to you today. This is something of real concern to our community. Some of that concern is uncertainty. Many impacts of the change in our constitutional status are very difficult to define at this point. Clearly, our relationship with Europe may be affected. That is a significant part of the rural economy. These are big issues. I expect that today’s session will dwell on some of that uncertainty and on some of the negatives of our present status and of our possible future independence. Despite the issues that we will cover today, as an industry and a sector we are optimistic about the future. Whatever constitutional arrangements prevail in Scotland, we see a bright future for farming and food production.
Q699 The Chairman: I gather that you have just given us a paper, which will cover some of the things I am about to ask you. Thank you for that. I think it would be fair to say that the members of the inquiry team here are not as familiar with the farming industry as with other industries. Perhaps you would describe how agriculture in Scotland is integrated with the rest of the UK. For example, what proportion of cereals, meat and fish produce is sold in Scotland and what proportion to the rest of the UK? Do you have any negative concerns about this if Scotland were to become independent?

Nigel Miller: Perhaps it is worth highlighting the basic structure of Scottish agriculture. It is probably very different from that of the rest of the UK, because 85% of Scotland's area is less favoured. That accounts for 60% of the UK area of disadvantaged land; it is a very significant hill region. That skews our production. In reality, the majority of our output is livestock-oriented: beef, lamb or milk. Our cropped area is probably just 500,000 hectares. Of that, spring barley will constitute a very significant part; we have something like 300,000 hectares of it. The wheat area is significantly smaller. We have a potato industry that uses only something like 31,000 hectares, yet it adds almost 10% of the value in output terms. Soft fruit, too, occupies a very small area but accounts for 7% in output terms. So it is quite a strange industry compared to that south of the border. The balance between beef production and dairy production is also very different. There are just under 500,000 suckler cows—specialist beef cows—and fewer than 180,000 dairy cows. So it is a very different industry. For that reason, our interest in the CAP and Europe is at a higher level than in other parts of the UK. A significant number of our producers have a high proportion of their income coming from European direct funding. That is a big issue for us. The average direct funding per hectare in Scotland is about €106. The figure for the UK is about €250, for England about €270 and for Ireland more than €300. That spells out the different history of farming support in Scotland. That is the background to how those sectors interplay with the rest of the UK. In reality, because of our whisky industry and the high percentage of spring barley production, in a normal year a significant proportion of that production is in Scotland. A significant amount of our wheat goes to distilling. We do have some movement of wheat stocks from southern Scotland to biofuels in the north of England. That is a new trade. There are also export opportunities from some of the east coast ports. It is often cheaper to move grain directly from east coast ports to Europe than to ship it south. That is the grain side of things, very briefly. The potato industry has a high reliance on seed potatoes and its largest market is England. Our soft fruit sector is of real value. A significant percentage of the marketing routes that it operates through are run by UK-based groups. As is the case for retail products in the rest of British agriculture, 70% of our products go to the major retailers; that is something we share. The milk sector is quite strange. In Scotland, it is very concentrated in the south and south-west—far more so than it was 20 years ago. We have lost half of our milk producers in the past 20 years. We are seeing a concentration in specialist units. Our average herd size is high: more than 150. So although the sector is small it is heavily invested, and, in terms of biological efficiency and genetics, near the top of the league. We obviously have a liquid milk market in Scotland, but there is also significant cheese production in the south-west and in Kintyre, which depends very much on the UK market. In many ways, along the south-west milk-field line beside Cumbria and the north-west of England, the interlinking of assets and infrastructure is quite strong. The red meat sector is the highest-value sector in gross terms, although it is not huge. Lambs are probably the quickest story: 60% of our lambs are shipped south of the border. They are not processed here but go for breeding or as prime or store lambs. A significant number of our prime lambs go to Wales and then to England for slaughter; we process only a small percentage of them. A significant number go for onward export. We are very dependent on
those links for our lamb production. Again, draft ewes—cast ewes—are processed almost exclusively in England. It is difficult to get exact figures for the beef sector, but probably 61% of our meat goes south of the border. Some of that will be packed and cut there, and relocated to Scotland for sale through the major retailers. We have links with Asda, and Sainsbury’s has links with Perth, taking product from Scotland and moving some of it south. However, probably the key customer for moving product back and forth is Tesco. A significant amount of its beef moves south to be packed for the whole of the UK. So there is quite a complex trail there that is difficult to disentangle. There are also significant beef exports to the continent at the quality end of our product. They have risen 16-17% over the past year or so. That is a significant part of our market as well. We also export to Ireland.

The pig sector has shrunk incredibly since the late 1990s when the stall ban came in. In the last year and a half we have seen a further loss of volume. We are now down to 32,000 sows and we have just lost our major processor in Broxburn. That will lead to a significant restructuring of the sector. The immediate problem is that we have undercapacity; probably something like 3,500 pigs a week will be moved to England for processing in Malton. The hope is that facilities will be developed in Scotland to absorb that undercapacity. The case of the Broxburn plant was seen as a slaughter issue, but in reality was not. The plant was mainly a processor; at least 80% of the jobs were to do with processing. Losing that processing capacity is a significant blow that means processing will take place in England and then the product may be moved back to Scotland. At the moment probably 60% of our fresh pig meat is eaten in England. Broxburn had big contracts with Asda, Marks and Spencer and others. So a significant percentage of output is taken out of Scotland. I hope that that has given you a brief rundown of our farming commodities.

The Chairman: Thank you very much. In view of the fact that I spent endless days if not months in the 1980s as Minister of Agriculture, I am probably not the appropriate person to ask the next question, so I will ask Lord Tugendhat to do it.

Q700 Lord Tugendhat: It has been suggested that because of the differences between the agricultural industries of this country and those in England, Scottish interests are not always best served in negotiations at European level. Do you feel that there is truth in that? If Scotland were represented independently, as a very small country by comparison with United Kingdom, would it be able to fight its corner more effectively?

Nigel Miller: Some of the tensions arise because the policy towards agriculture is different north and south of the border. Probably the economic importance to Scotland is higher. It supports our largest manufacturing sector and is also an export driver. The Scottish Government give significant priority to our food policy. Probably it is those tensions that impact at Brussels level. Certainly since devolution, agriculture in Scotland has benefited significantly, but our links with Westminster have deteriorated. Over the past year or 18 months, the linkage with Ministers at Westminster improved significantly; communication was at a reasonably high level and we had good access. Whether that will continue over the next few months is critical for us. There is definitely tension because the main priorities for the UK Government are different from those for Scotland. There is no formal mechanism—or at least no transparent mechanism—for Scotland to feed into a UK position. I believe that in previous Administrations, the Cabinet Secretary chaired a committee that perhaps involved an English, a Welsh, a Scottish and an Irish Minister, and then took forward a UK position. Our understanding is that that no longer happens. That would be a significant and positive vehicle for generating a feeling that Scottish views were being taken into the mix in any UK position. Over the last few days in Europe, the position articulated by the UK...
Government was far from the position of the Scottish Government, and far from our own position.

**Q701 The Chairman:** I will just put on record that it was very different in my day. We always had a Scottish Minister with us, and Scotland played a very strong part—probably the major part in the case of the fishing industry. Obviously times have changed. One issue here is that it is always the bigger countries that have the most sway in European negotiations. Do you think that an independent Scotland—a much smaller nation—would have the same clout?

**Nigel Miller:** Inevitably, if you are a smaller country and not a net contributor, your leverage will be reduced. However, it would be equally true to say that if you are part of a significant member state that is a net contributor, has political capital and is arguing a case that is counter to what you want, that is a negative as well. The position of the UK on direct support to farming in the budget is totally counter to that of the Scottish Government.

**Q702 Lord Forsyth of Drumlean:** Having sat at many Agriculture and Fisheries Council meetings, I echo what the Chairman said about direct input pre-devolution. Are you saying that an independent Scotland would be able to be more influential in the area of agriculture? The second question is: if what the Spanish Foreign Minister suggested—that Scotland would not automatically be able to join the European Union but would have to negotiate its way in—happened, what would be the indications for Scottish farming and agriculture?

**Nigel Miller:** I think that an independent Scotland could articulate its case clearly. Probably our situation is more aligned with those of other European countries. Therefore, we might get carried along with the general mood in Europe. Scotland’s leverage as a small country if it wanted something different would probably be very light. Certainly it would have to work with other member states with similar industries—for example, Ireland—to have any real impact on detailed negotiations. The satisfying thing would be that it would articulate what Scotland required. On Scotland’s status, clearly it is not the only devolved region of Europe that might look towards independence. That creates a real political challenge for the EU. The point you made is very valid; that is one of the big uncertainties. When the Scottish Government looked for reassurance from the European Commission that there would be an automatic and seamless move to continued membership, the door did not seem to be open.

From my point of view as a representative of the union in Scotland, we have real concerns about losing the link to Europe. Probably €600 million comes into Scotland every year from that source, and we do not want to see it disappear. So that is a risk factor; there is no denying that. The converse is that if Scotland were a member state today, under the present negotiations and given the convergence criteria that were pushed by the European Commission in its text of last October, we are clearly well below the 90% average of European member states, and so under the convergence rules would expect to get significantly more funding from this reform. As a region of a member state, although we are nearly on a par with Latvia and Lithuania, the bottom two states, we will get no dividend whatever. So you could argue that as a member state without any ability to negotiate, with seamless accession and under convergence we would suddenly get a significant dividend. Those are the two counterarguments.

**Q703 The Chairman:** You will have seen press reports of the comments of the Spanish Foreign Minister that if Scotland became independent, it would take a long while to negotiate re-entry to the EU. I presume that that would be a difficult period for Scottish farmers.
**Nigel Miller**: I totally accept that there is a real risk for us in going down that path, and that any fracture in our relations with Europe would be dangerous for our industry, and particularly for the LFA regions. Any fracture in, or problems with, trade links would be pretty significant because we are export-oriented. Certainly in our red meat sector, the premium value of our product depends on good access to Europe and on a good image. Whisky might overcome any such issues. It is a big part of our economy and requires export markets.

**Q704 Lord Forsyth of Drumlean**: I am sorry to press you on this, but I am not sure whether you mean it. You gave me the impression that from the point of view of your industry, an independent Scotland would be better off because you would be able to focus on agricultural issues that were Scottish, and because you would get a bigger subsidy from the European Union than you do as part of the United Kingdom. Is that what you are saying?

**Nigel Miller**: I was saying that there are two sides to the story. One is that if Scotland immediately slots into a position of being a member state, under present European negotiations on CAP reform there would be an immediate dividend. That is one side of the argument. The other side is that we might not get entry to the European Union, and if we did it might be on very unfavourable terms; we might have to negotiate a totally different package. Therefore, what appears to be a definite win through being an independent member state might result in a serious fracture in our relations with Europe and in our funding from Europe. So for us there is a huge risk there. My members will have very different views. We have members who are fixed and focused on independence, and we have a group who are strongly unionist. We also have many in between or undecided, some of whom - although they voted SNP at the last election, who would think that separation may not be helpful and was too high a risk. Where that mix will settle down in 2014 I do not know. A lot of that is down to uncertainty. If there was certainty about Scotland’s ability to be a member of the EU, and what status it would have, and if there was certainty about what currency we would use and what level of debt we would carry, that might tip the arguments strongly one way or the other. At the moment, the level of uncertainty is such that it would be difficult to say that there was a huge advantage to either course, although the status quo is obviously a lower risk.

**Q705 Lord Levene of Portsoken**: Mr Miller, I would like to ask a couple of things about the numbers on the sheet you gave us. You listed the top 10 food markets. Where does the UK stand? What sort of number are we looking at?

**Nigel Miller**: The UK is by far the biggest market. Sorry, I should have given you a more complete briefing. It would have shown that 66% of beef tonnage, 56% of sheep meat and 66% of pig meat goes to the UK market. So in the red meat sector, a very significant part of our production is sold in the UK.

**Lord Levene of Portsoken**: My other question concerns key food sectors. The increases over 2007 are huge—absolutely amazing. Is there any particular reason for that? The totals are up 45%, 99%, 114% and 161%. Those are enormous increases.

**Nigel Miller**: That was a period of significant food inflation; that is factored into the figures. Those figures are not the latest figures. In 2011 we were up to £5.4 billion in export terms. That was accounted for by £4.2 billion from drink—mostly whisky but some gin—and £1.2 billion from food. That growth continues at a significant rate, and is one of the main priorities of our Government. The whisky sector has gone into an extraordinary period because markets in Asia have opened up. Some brands have increased their output by 25% in
a year; there has been spectacular growth. Over this period, we have also seen the red meat and beef markets opening up in Europe. Scotland quickly re-established high-value trade with Italy and France. The beef sector is now a significant contributor. It was excluded from those markets because of BSE.

**Lord Levene of Portsoken:** Has that gone away now?

**Nigel Miller:** Yes, so the export route is open. That is one reason for the dividend.

**Q706 Lord Forsyth of Drumlean:** Do you worry about the centre of gravity of an independent Scotland changing because the economy would be much more dependent on oil and financial services for its revenues?

**Nigel Miller:** Our main concern is our own sector. Yes, we would have concerns about the economic viability of a separate nation. The balance between the public and private sectors would concern us. We would want to ensure that we had a viable economy going forward. Certainly, tax levels would be a significant factor that our members would be concerned about after independence—and also the level of debt that Scotland would carry. The reality is that in some of our regions, such as Orkney or Dumfries and Galloway, more than 10% of the economy is driven by agriculture. That is well recognised by the Scottish Government—not just the present Government but the previous devolved Government, in which Ross Finnie was Rural Affairs Minister. We would be fairly confident, especially given the significance of agricultural exports, that after independence we would get a good deal.

**Q707 The Chairman:** If Scotland were independent, would there be losses in terms of exports to the rest of the United Kingdom, because these would no longer be domestic markets? Is there any concern among your members at that possibility?

**Nigel Miller:** There is concern. For some sectors such as whisky, we do not see a risk. France and the US are big markets, and we are growing markets in Asia. People will keep drinking whisky. For other products, being non-British would be a risk. In the present situation, the Scotch beef brand is widely recognised in the south of England; we have big markets there. At the moment, in dead weight terms, it is worth 360p-plus per kilo. The figure for Northern Ireland is significantly less. If we were a non-British producer, major retailers might be tempted to source red meat from Northern Ireland. Those are the sort of risks. Our soft fruit sector is heavily integrated with UK retailers. If there was not a union jack on the punnet or tray, that might be a negative. Likewise, although our pig sector is small, it is very dependent on securing the best shelf of the fresh-meat counter for pork. Marks and Spencer regard it as a high-value brand because of its health and welfare status; the SSPCA inspects every herd. After independence it might stay on that shelf, but if it were not British it might not. That is a real concern.

**Q708 Lord Tugendhat:** Do you think that you would get a higher payout from the CAP than the UK does at present?

**Nigel Miller:** This would depend completely on negotiations with Europe. If by some magic scenario we were a member state today, under the present negotiating package Scotland would be a significant beneficiary of convergence criteria. We might be looking at €180 a hectare or more on a flat-line budget, compared to €106 a hectare. That is an extraordinary difference.

**Lord Tugendhat:** That is dependent, as you said, on terms that might be negotiated for getting into the EU. It also hinges on the level of agricultural support going forward.
Nigel Miller: Absolutely. I have stressed that this is a theoretical concept that will be repeatedly brought up in the debate over independence, because it is such an easy win to define. The Commission has repeated that convergence in the long term is where it wants to go—and that it wants convergence within member states. Even the UK Government in the last few days said that convergence was a priority for them. So this is something that will not go away.

Q709 Lord Forsyth of Drumlean: Hypothetically, if Scotland were independent and Scottish farmers got this extra 10% or whatever it is per hectare, what would be the reaction of your farming colleagues south of the border? How do you think the rest of the UK, which after all presumably would have a role in agreeing what the regime should be, would react—because it is not a steady-state position?

Nigel Miller: It would be a bit presumptuous of me to guess what my colleagues south of the border and in Northern Ireland would think. I cannot imagine that they would welcome Scotland being better off than it is now. But to be honest, I cannot afford to have those feelings. I am elected by Scottish farmers; that is all.

Lord Forsyth of Drumlean: I quite understand that, but it is a bit like the argument on corporation tax. Some people say that a Scottish Government could cut corporation tax, and seem to presume that the rest of the UK would just watch while it was disadvantaged rather than cutting corporation tax from a wider tax base. You farm in the borders. I wonder whether your colleagues on the other side of the border, faced with a circumstance where they were greatly disadvantaged, would not press the Government of the rest of the UK to change their tax regime. You say that this is an easy point that can be made in the debate, but it implies a steady state. My experience of politics is that life is not like that; if you disadvantage or advantage one group relative to another, usually there is an equal and opposite reaction.

Nigel Miller: I totally accept that that is the case. The reality is that this is not an amazing rule that was dreamt up by Scotland, by the Scottish Nationalists or by myself; it is what the European Commission dreamt up. It considers that converging budgets throughout Europe is where the CAP must go, and the reality is that farmers south of the border are more heavily supported per hectare than Scottish farmers. You could say that Scotland is hugely disadvantaged and is looking over the border saying that there must be an equal and opposite reaction. I do not think that you should be too sympathetic to farmers south of the border.

Q710 Lord McFall of Alcluith: George Lyon, a farmer himself and the Liberal Democrat MEP, told Farmers Weekly in August that a large number of farmers were borrowing millions to invest in wind turbines and hydro schemes, and that long-term funding was guaranteed by substantial ongoing subsidies from UK consumers in the guise of feed-in tariffs. He said that without the subsidies, which are estimated to cost UK consumers more than £400 million a year in higher electricity bills, none of these projects would stack up financially. Is that an uncertainty going forward?

Nigel Miller: There is inevitable uncertainty where any sector relies heavily on ongoing subsidies. That is the reality of where we are. Without that money, most of these projects would not stack up. The counterargument is that energy prices almost certainly will escalate over the next few years. They may escalate to a level where these investments economically can stand alone. If that is the case, the risk factor is low—but unless that happens, there would be a huge risk if the flow of support were severed in any way.
Lord McFall of Alcluith: George Lyon asked for cast-iron guarantees quickly. Would you go along with that?

Nigel Miller: We put this question to Members of the Government. It was certainly put at a recent clean and renewable energy conference. There have been general assurances that the Scottish Government would never move to disadvantage these investors. However, we have not seen the stream of funding that would allow that to happen.

Q711 The Chairman: Are there any other issues or concerns that you would like to put to our Committee about the potential benefits or losses if Scotland became independent?

Nigel Miller: Your questions have flushed out the main areas of concern. Because we are in a world where our future relationships with Europe and the UK are uncertain, we can only estimate or guess at impacts. I stress again that for many of our members, the level of debt and the ongoing tax liabilities that Scotland would have would be a significant issue. They are keen to understand if that will impact radically on their businesses, and on their ability to invest. That is one area on which we have not spent a lot of time but where there are concerns.

The Chairman: Do you want to say any more about that?

Nigel Miller: I am not able to elaborate further because we have not seen the numbers; we just have concerns. Your last question related to FITs and ROCs. These come from Westminster and the Westminster Exchequer. Therefore in a small nation like Scotland, how will we generate the tax levels that will be required to keep feeding the subsidies into the economy, given that we have significant spends in other areas? You would really want a breakdown of the numbers for how a Scottish economy would work. Hopefully in the debate between now and 2014 that sort of analysis will take place and we will move away from some of the obvious headline issues that are being articulated at present.

Q712 The Chairman: So would it be fair to say that in Scottish agriculture, the key issue with Scottish independence is the uncertainty that would arise over whether you would continue to be a member of the EU or not, over the period of uncertainty that, it seems likely, would be involved in that, and over the eventual outcome?

Nigel Miller: That sums it up—and another key uncertainty that has been fuelled by various statements is that if Scotland were to become independent, what currency would it use? There have been suggestions that it would remain in the sterling zone. There have been other suggestions that that would not be possible. Clearly, if Scotland were not in the sterling zone, it would have no impact on the Bank of England’s regulation process. Or are we going to be part of the euro? Because we are so heavily export-oriented, the exchange rate between the euro and sterling is absolutely critical. The changes that we have seen over the past year have probably stripped 8-9% on average from our competitiveness in Europe. That will impact on land prices and on direct support. Some of the success that we had in driving up our exports was because of the favourable exchange rate. Things like that are quite significant to us. Being outwith the sterling zone might or might not be a problem for us.

The Chairman: We have covered the Bank of England with a number of other witnesses. Such issues have been a prominent part of our inquiry. We do not need to go into them now, but we understand that you, too, have concerns about them. Mr Miller, thank you very much indeed. Farming is not an area that has surfaced much in our discussions so far, and it has been very helpful to hear your evidence.
Nigel Miller: Thank you for your time.
Please accept the following short representation, on behalf of Newcastle International Airport Ltd, to the Call for Evidence on The Economic Implications for the United Kingdom of Scottish Independence.

1 The possible devolution of APD to Scotland raises huge issues for other regional airports, particularly those closer to the Scottish border. Devolving APD to the Scottish administration, given their keenness to reduce the rate of APD in order to give Scotland a competitive advantage, would have a devastating impact upon Newcastle Airport.

2 We have set out an alternative proposal to address the impact APD is having upon regional airports and the economies they serve. This proposal would involve the varying of APD rates according to the level of congestion at an airport, rather than where that airport is located. This approach would in our opinion be legal under EU State Aid rules, and would be fair. A devolved approach, whereby passengers — who are essentially mobile between airports — could pay significantly less north of the border than they would pay south of the border, would in our view be certainly very unfair. It would lead to the loss of a significant number of direct and indirect jobs in the North East of England and make this region even more of an economic backwater than it is or deserves to be.

3 In the event of devolved APD, and should the Scottish Government elect to reduce the rate or cancel the Duty altogether, we anticipate that both passengers and airlines would move from Newcastle to airports north of the border, particularly Edinburgh. For example, Emirates, an airline we have worked hard to acquire and retain, would be able to offer its customers far cheaper flights from Edinburgh and would therefore be likely to consider relocating its service. We are certain there would be numerous other examples, and we are genuinely concerned that the future viability of Newcastle Airport could be threatened.

4 The consequences for the economy of the North East of England of such a move would be equally devastating. The Eddington Report concluded that the region is already relatively poorly connected when compared to other UK and European city regions. The economy of the region also has a range of other disadvantages. The loss of a number of critical air services would be a hammer blow, setting the region back both in terms of private sector activity and the outlook and aspirations of its population. Large and international employers could have to review their presence in the region, and the tentative growth seen in inbound tourism would be reversed.

11 June 2012
Reform Scotland, Professor Jim Gallagher and The Institute of Chartered Accountants of Scotland (ICAS)—Oral evidence (QQ 623-640)

Reform Scotland, Professor Jim Gallagher and The Institute of Chartered Accountants of Scotland (ICAS)—Oral evidence (QQ 623-640)

Transcript to be found under Professor Jim Gallagher, The Institute of Chartered Accountants of Scotland (ICAS) and Reform Scotland and—Oral evidence (QQ 623-640)
Willie Rennie MSP, Ruth Davidson MSP, Patrick Harvie MSP and Johann Lamont MSP—Oral evidence (QQ 587-600)

**Willie Rennie MSP, Ruth Davidson MSP, Patrick Harvie MSP and Johann Lamont MSP—Oral evidence (QQ 587-600)**

*Transcript to be found under Ruth Davidson MSP, Patrick Harvie MSP, Johann Lamont MSP and Willie Rennie MSP—Oral evidence (QQ 587-600)*
The Fiscal Implications of Scottish Independence

Abstract

This submission examines the fiscal implications of Scottish independence for both Scotland and the rest of the UK. These would depend on a number of factors, including world hydrocarbon prices, the extent to which an independent Scotland accepted responsibility for its proportionate share of the UK national debt, and what happened to the Orkney and Shetland Islands. A number of scenarios are considered on the assumption that Scotland becomes independent soon after a hypothetical ‘yes’ vote in the 2014 referendum. At one extreme, Scotland would have a fiscal deficit approaching 6 percent of GDP. This would be the case if hydrocarbon prices fell sharply, the Orkneys and Shetlands remained in the UK, and Scotland shouldered its full share of the national debt. Under these conditions, Scotland might face a funding crisis and the UK might have to step in to help, just as it is currently helping to bail out Ireland. At the other extreme, Scotland might have a small fiscal surplus. This would be the case if hydrocarbon prices remained buoyant, the Orkneys and Shetlands stayed within the Scottish fold and if Scotland took no responsibility for the UK national debt and associated interest payments. In fiscal terms, the rest of UK might gain or lose from the departure of Scotland, but the effect would be small – less than 0.5 percent of GDP either way.

Introductory Remarks

Scottish independence would affect the rest of the UK economy and government finances in a variety of ways. The following are some of the most important items that are relevant in this context.

Economic Cooperation: Given an amicable dissolution, independence should not have a serious impact on economic cooperation between Scotland and the rest of the UK. Trade and investment would continue much as before, although the exact outcome would depend on Scotland’s choice of currency and its broader economic policy. It is unlikely there would be a repetition of the trade war which marred Anglo-Irish economic relations during the 1930s.

Currency: Scotland would have a number of options following independence. SNP leader Alex Salmond has stated that an independent Scotland would keep sterling for the time being, but would keep its options open for the future. If permitted, it could join the euro. Or it could have its own currency, which could either float or else shadow the pound or the euro. Each of these options would have somewhat different economic implications for Scotland and also for the UK.

The National Debt: When the Anglo-Irish Treaty was signed on 6th December 1921, the newly formed Irish Free State agreed to assume responsibility for a proportionate part of the

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United Kingdom's debt, as it stood on the date of signature. It is probable that similar arrangements would be made following Scottish independence. In a recent TV interview, Alex Salmond stated that an independent Scotland would take its proportionate share of the national debt, although this cannot be taken for granted. He also stated that Scotland would take no responsibility for the outstanding debts of the Royal Bank of Scotland, citing in justification the £250 billion of mainly Scottish oil revenue that has gone to the UK Treasury since production began in the North Sea. By the time of independence, assuming a 'yes' vote in a 2014 referendum, Scotland's per capita share of the UK national debt might be in the region of £120 billion, and associated interest payments around £5 billion a year. Faced with the prospect of interest payments on this scale, it would be rational for the nationalists to seek to minimize Scotland's responsibility for the national debt.

Defence: Military arrangements would alter following Scottish independence. Scotland would take over some existing military facilities and would finance its own armed forces. In response, the UK might reduce its own defence expenditure, or alternatively might continue spending as much as before so as to preserve its previous military capacity. There might also be some form of military cooperation between the Scotland and post-independence UK. One bone of contention would be the Faslane naval base on Gare Loch which serves as home base for the UK fleet of Trident submarines as well as conventionally-armed nuclear powered submarines. There has been ongoing agitation against this base and its future would be uncertain. If the government of an independent Scotland insisted on the removal of these submarines they would have to be relocated elsewhere. Alternatively, the new Scottish government might allow the UK to retain the Faslane base, following the example of the Ukrainian government which allowed the Russians to keep their naval base in Sevastapol after the break-up of the Soviet Union. This would be economically advantageous for Scotland, both in terms of the jobs it would provide and any rent that Scotland might receive.

North Sea Oil and Gas: Under the international law of the sea Scotland would be entitled to an exclusive economic zone (EEZ) covering a significant area of the North Sea. This would give Scotland access to substantial tax revenues that currently accrue to the central UK government. The Scottish government has estimated what the effect would be on the assumption that what it calls the "geographical share" of oil-related production and revenue is assigned to Scotland. This share is based on the "median line", which projects outwards into the North Sea from the coastline at the boundary between England and Scotland. This is the area that might belong to Scotland's exclusive economic zone in the event of independence. It is estimated that approximately 90 percent of current UK North Sea revenue derives from resources located within this area.

The Orkney and Shetland Islands: There is concern in the Orkney and Shetland islands about membership of an independent Scotland, and in the event of Scottish independence it is

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69 Article 5 of the Anglo-Irish Agreement states: "The Irish Free State shall assume liability for the service of the Public Debt of the United Kingdom as existing as the date hereof and towards the payment of War Pensions as existing at that date in such proportion as may be fair and equitable, having regard to any just claim on the part of Ireland by way of set-off or counter claim, the amount of such sums being determined in default of agreement by the arbitration of one or more independent persons being citizens of the British Empire". [http://www.nationalarchives.ie/topics/anglo_irish/dfaexhib2.html](http://www.nationalarchives.ie/topics/anglo_irish/dfaexhib2.html)


conceivable that these islands would opt to remain part of the UK. The Scottish National Party has conceded that this would be a feasible option for the islanders. It would have important implications for the control of North Sea oil and gas. According to the normal principles of international law, there would be an exclusive economic zone around the Orkneys and Shetlands if they were to remain within the UK. This would give the UK control of part of the North Sea that would otherwise be under Scottish control. The fact that the Orkneys and Shetlands are located close to Scotland but several hundred miles from the English shore is no obstacle to them remaining in the UK, nor under international law does it prevent the UK from having an EEZ based on these islands. The exact boundaries of such an EEZ are uncertain and would have to be settled by negotiation between the parties involved. Media reports claim that a quarter of current UK North Sea revenue derives from resources located within the potential EEZ of the Orkneys and Shetlands. This is about 30 percent the North Sea revenue that Scotland might otherwise expect to enjoy following independence.

**Structure of the Paper**

The structure of this paper is as follows. It begins with a brief comparison of the recent fiscal situation in Scotland and the rest of the UK. This confirms the conventional view of Scotland as a high spending country of the UK. Next there is section which projects Scottish government expenditure and revenue forwards to 2016-17. The numbers presented are the author’s own estimates. There is then a section on the fiscal implications of independence for Scotland. This is followed by a discussion of the fiscal implications for the rest of the UK. These sections are linked; since in most cases Scotland’s fiscal gain or loss following independence is matched by an equal but opposite change in the fiscal balance of the rest of the UK. For example, if an independent Scotland takes responsibility for a certain category of expenditure, this will no longer be a UK responsibility and will no longer be included in the UK national accounts. The paper concludes with a few general observations. The main conclusion is that a newly independent Scotland would probably have a fiscal deficit, although there is considerable uncertainty regarding the scale of this deficit. Two factors would be of particular importance in this context: the future behaviour of oil and gas prices; and the extent to which an independent Scotland accepted responsibility for its proportionate share of the UK national debt. A second, and more obvious, conclusion is that Scottish independence would have only a minor effect on the UK fiscal situation. A loss or gain, which is highly significant for a small economy like Scotland, is much less important to a much larger economy like post-independence UK.

**A Comparison**

A useful starting point to analyse the fiscal impact of Scottish independence are the official public sector accounts for Scotland, henceforth known as GERS. This document gives detailed information of Scottish expenditure and revenue, together with estimates of Scotland’s “geographical” share of North Sea revenue. It also contains extensive data for the UK as a whole.

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74 BBC interview with Angus MacNeil, the SNP’s rural affairs spokesman, reported in the Daily Telegraph, 20 March, 2012.
http://www.scotland.gov.uk/Publications/2012/03/9525/0
Table 1 presents information on per capita expenditure and revenue in Scotland and the rest of the UK for the fiscal year 2010-2011. Expenditure includes both current and capital items. It is divided into two broad categories: identifiable and non-identifiable. The former is expenditure which is clearly associated with a specific country, and includes virtually all expenditures on health, education, social protection, transport, public order and safety. Non-identifiable expenditure is expenditure that cannot be associated with particular country of the UK but is instead incurred on behalf of the UK as a whole. In the public sector accounts, most non-identifiable expenditures are conventionally assigned to individual countries in proportion to their share in UK population. This convention explains why per capita defence and interest payments in table 1 are the same in Scotland and the rest of the UK.

Table 1: Expenditure and Revenue 2010-2011

<table>
<thead>
<tr>
<th>£ per capita</th>
<th>Scotland</th>
<th>Rest of UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifiable expenditure</td>
<td>10,051</td>
<td>8,718</td>
</tr>
<tr>
<td>Interest</td>
<td>708</td>
<td>708</td>
</tr>
<tr>
<td>Defence</td>
<td>625</td>
<td>625</td>
</tr>
<tr>
<td>Other non-identifiable expenditure</td>
<td>402</td>
<td>510</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>11,785</td>
<td>10,560</td>
</tr>
<tr>
<td>Current non-North Sea revenue</td>
<td>8,640</td>
<td>8,709</td>
</tr>
<tr>
<td>North Sea revenue:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita shares</td>
<td>141</td>
<td>141</td>
</tr>
<tr>
<td>Geographical shares A</td>
<td>1,521</td>
<td>15</td>
</tr>
<tr>
<td>Geographical shares B</td>
<td>1,100</td>
<td>53</td>
</tr>
<tr>
<td>Total revenue:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita shares</td>
<td>8,780</td>
<td>8,850</td>
</tr>
<tr>
<td>Geographical shares A</td>
<td>10,160</td>
<td>8,724</td>
</tr>
<tr>
<td>Geographical shares B</td>
<td>9,740</td>
<td>8,762</td>
</tr>
<tr>
<td>Net fiscal balance:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita shares</td>
<td>-3,005</td>
<td>-1,711</td>
</tr>
<tr>
<td>Geographical shares A</td>
<td>-1,625</td>
<td>-1,837</td>
</tr>
<tr>
<td>Geographical shares B</td>
<td>-2,405</td>
<td>-1,798</td>
</tr>
</tbody>
</table>

Source: Author’s own calculations based on GERS.

Government revenue from the North Sea is shown separately in table 1. This is assigned to countries in three different ways. These correspond to different assumptions about the
ownership of North Sea resources and about the identity of the Orkney and Shetland Islands. In the assignment labelled “Per capita shares”, Scotland receives slightly more than 8 percent of UK North Sea revenue, in accordance with its share in total UK population. This assignment assumes that North Sea hydrocarbons belong to the UK as a whole and that no individual country of the union has a privileged claim over the revenue they generate. The assignment labelled “Geographical shares A”, assumes that North Sea hydrocarbons belong mainly to Scotland, and the revenue from these is allocated according to the principles of territorial control applicable if Scotland were an independent country. GERS estimates that in this case Scotland would get about 90 percent of total UK revenue from the North Sea. This leaves the rest of the UK with very little. In the assignment labelled “Geographical shares B”, Scotland excludes the Orkney and Shetland Islands which are classified as part of the rest of the UK. The share of these islands in UK North Sea revenue is assumed to be 25 percent.

It is well-known that Scotland is a high spending country. This is clear from table 1. Identifiable per capita expenditure is £1,300 a year (15 percent) greater in Scotland than the average for the rest of the UK. Amongst the biggest contributors to the high level of spending in Scotland are social protection, transport, health and housing in that order. The implications of this difference in expenditure depend on what is assumed about the allocation of North Sea revenue. If this revenue is allocated according to population shares, total revenue per capita is similar in Scotland to the rest of the UK, and there is nothing to offset higher Scottish spending. As a result, the per capita fiscal deficit is £1,300 larger in Scotland than in the rest of the UK. The other scenarios allocate most North Sea revenue to Scotland. This modification has dramatic results. It increases Scotland’s North Sea revenue from £141 per capita to £1,521 or £1,100 depending on how the Orkneys and Shetlands are classified. This increase is sufficient to offset most or all of the difference in expenditure between Scotland and the rest of the UK. Even so, the Scottish fiscal deficit is still very large. Note that under any scenario, the per capita fiscal deficit of the rest of the UK is virtually the same. This is because the population of the UK is so large. On a per capita basis, a few billion pounds of oil revenue makes a big difference to Scotland, but spread over 57 million people in the rest of the UK the effect is relatively small.

**Scotland’s Future Expenditure and Revenue: within the UK**

Table 2 contains some projections for Scottish government expenditure and revenue up to 2016-17. These projections are derived from official accounts which assume that Scotland remains in the UK. The numbers for 2010-11 come from GERS and are projected forwards on the basis of Office for Budget Responsibility (OBR) projections for the UK as a whole.

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76 **OBR’s Economic and fiscal outlook: selected tables,**


With the exception of North Sea revenue, each category of per capita expenditure and revenue is assumed to grow at the same percentage rate in Scotland as in the UK as a whole. The share of defence in Scottish total expenditure, excluding interest, is assumed to remain constant at the 2010-2011 level (5.1%). Scotland is allocated its 2010-11 “geographical” share of total UK North Sea revenue (90.5%).

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Table 2. Scottish Net Fiscal Balance 2010-11 to 2016-17

<table>
<thead>
<tr>
<th>Description</th>
<th>2010-11</th>
<th>2015-16</th>
<th>2016-17</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Public sector debt interest</td>
<td>3.7</td>
<td>5.1</td>
<td>5.4</td>
</tr>
<tr>
<td>(2) Defence</td>
<td>3.3</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>(3) Other expenditure</td>
<td>56.8</td>
<td>60.9</td>
<td>61.5</td>
</tr>
<tr>
<td><strong>(4) Total expenditure</strong></td>
<td><strong>63.8</strong></td>
<td><strong>69.6</strong></td>
<td><strong>70.5</strong></td>
</tr>
<tr>
<td>(5) Non-North Sea revenue</td>
<td>45.2</td>
<td>56.4</td>
<td>59.9</td>
</tr>
<tr>
<td>(6) North Sea revenue (geographical share)</td>
<td>8.0</td>
<td>5.4</td>
<td>4.7</td>
</tr>
<tr>
<td><strong>(7) Total revenue</strong></td>
<td><strong>53.1</strong></td>
<td><strong>61.8</strong></td>
<td><strong>64.6</strong></td>
</tr>
<tr>
<td><strong>(8) Net fiscal balance ((= \text{row (7)} - \text{row (4)}))</strong></td>
<td><strong>-10.7</strong></td>
<td><strong>-7.8</strong></td>
<td><strong>-5.9</strong></td>
</tr>
</tbody>
</table>

Balance as % Scottish GDP (incl. oil)                             | -7.4    | -4.7    | -3.5    |
Balance as % of UK GDP                                            | -0.7    | -0.4    | -0.4    |

**Memo:**
UK Balance as % of UK GDP                                         | -9.2    | -2.8    | -1.1    |

Source: GERS, OBR and author’s own calculations

Scotland is assigned a constant “geographical” share of North Sea revenue equal to 90.5 percent, which is the share given by GERS for 2010-2011. The method of estimation used for table 2 is elementary but, hopefully, the projections are of the right order of magnitude. It must be stressed that these projections assume that the OBR projections for the UK as a whole are correct.

Points to note are as follows:

- Under the impact of Chancellor Osborne’s deficit reduction programme, the UK fiscal deficit virtually disappears by the end of the period. From 9.3 percent in 2010-11 it falls to only 1.1 percent of GDP in 2016-17. This may turn out to be overoptimistic.
- The Scottish deficit also declines but at a slower pace, and even by the end of the period it is still 3.5 percent of GDP.
- The slow pace of decline in Scotland’s deficit is partly due to the assumed behaviour of North Sea revenue. Such revenue falls rapidly during the last few years of the OBR projection and by the end of the period is only half what it was at the beginning in real terms. This development is explained in part by a combination of falling production and falling prices for North Sea hydrocarbons from 2012-13 onwards. The two are, of course, linked. With higher prices, there would be more production...
in the North Sea, and the decline in revenue might be halted or even reversed for a significant time\textsuperscript{77}.

**Fiscal Implications for an Independent Scotland**

The projections in table 2 give some indication of the fiscal situation facing a newly independent Scotland. However, certain modifications are required to get a complete picture. Table 3 presents three alternative scenarios for the year 2015-16, which is the first fiscal year following the planned 2014 independence referendum. In this table, the baseline fiscal balance, which is given in table 2, is adjusted in various ways. The quantitative adjustments are hypothetical and are designed to illustrate the potential orders of magnitude.

<table>
<thead>
<tr>
<th>Table 3. An Independent Scotland: Net Fiscal Balance 2015-2016</th>
<th>Alternative Scenarios</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>£ billion</strong></td>
<td><strong>Intermediate Scenario</strong></td>
</tr>
<tr>
<td><strong>Baseline balance</strong></td>
<td>-7.8</td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
</tr>
<tr>
<td>Defence expenditure</td>
<td>+1.2</td>
</tr>
<tr>
<td>Interest payments</td>
<td>0.0</td>
</tr>
<tr>
<td>North Sea revenue:</td>
<td></td>
</tr>
<tr>
<td>Orkneys &amp; Shetlands</td>
<td>0.0</td>
</tr>
<tr>
<td>Production &amp; prices</td>
<td>+2.6</td>
</tr>
<tr>
<td><strong>Total adjustments</strong></td>
<td>+3.8</td>
</tr>
<tr>
<td><strong>Final balance</strong></td>
<td>-4.0</td>
</tr>
<tr>
<td>% Scotland GDP</td>
<td>-2.4</td>
</tr>
</tbody>
</table>

Under the best case scenario, Scotland gains in three different areas as follows:

- **Defence**: an independent Scotland is content with modest armed forces along Nordic lines. It has no need for costly aircraft carriers or Trident submarines. The assumed savings are £1.2 billion a year, which is about a third of the Scotland’s notional share of UK defence expenditure.
- **Interest**: The nationalists take no responsibility for Scotland’s share of the UK national debt, thereby avoiding annual interest payments equal to £5.1 billion.
- **North Sea revenue**: Hydrocarbon prices and production remain buoyant. In money terms Scotland’s North Sea revenue is the same in 2015-16 as it was in 2010-2011. This represents a gain for Scotland of £2.6 billion as compared to the baseline scenario, which assumes falling revenue from this source.

After these favourable adjustments there is a fiscal surplus in 2015-16 equal to £1.1 billion or 0.7 percent of Scottish GDP.

The worst case scenario retains the savings on defence expenditure, but makes the following assumptions about the remaining items:

- **Interest**: The nationalists accept Scotland's full per capita share of the UK national debt, so there are no savings on this item for Scotland.
- **Orkneys and Shetlands**: These islands remain within the UK and Scotland loses 30 percent of its North Sea revenue. This represents a loss for Scotland of £1.5 billion.
- **Prices and production**: Hydrocarbon prices and production are lower than envisaged under the baseline scenario. As a result, revenue from the North Sea falls by a further third in addition to the loss due to the exclusion of the Orkneys and Shetlands from the Scottish fold. This represents an additional loss of around £1.3 billion\(^78\).

Under this scenario the fiscal deficit is equal to £9.4 billion which is equivalent to 5.9 percent of Scottish GDP.

There is also an intermediate scenario in which Scotland accepts responsibility for its per capita share of the UK national debt, but North Sea revenue remains buoyant because of high hydrocarbon prices and the Orkneys and Shetlands remain in the Scottish fold. In this scenario, there is a modest fiscal deficit equal to 2.4 percent of Scottish GDP, which is a little smaller than the UK deficit in the same year.

Table 3 reveals the range of potential outcomes. Under the best case scenario, Scotland has a small fiscal surplus. Its high level of expenditure on health, education, transfer payments and the like is more than offset by buoyant North Sea revenue and savings in interest payments. Under the worst case scenario, Scotland has a large fiscal deficit. The government's expenditure continues at a high level, but North Sea revenue has fallen sharply and it must also service a large inherited national debt.

**Fiscal Impact on the UK**

In most cases, the fiscal impact of Scottish independence on the UK is equal in magnitude but opposite in sign to its impact on Scotland. If Scotland receives North Sea revenue that would otherwise have gone to the UK government, this will represent a loss for the post-independence UK. Conversely, if Scotland takes responsibility for some item of expenditure, this will normally imply a saving for the UK. For example, if Scotland takes over responsibility for a share of the UK national debt, Scotland's resulting interest payments will be matched by an equal reduction of UK interest payments. However, this one to one correspondence may not be universally valid. In the official UK accounts for Scotland on which table 2 is based, government expenditure contains a notional allowance for non-identifiable expenditures on items such as defence and international services. Many of these items are “public” goods whose benefit to the rest of the UK is largely unaffected by whether or not Scotland becomes independent, or by what an independent Scotland would spend on them. Following the departure of Scotland, there would be scope for the UK to make some economies in this area, but major reductions would damage UK military capacity or its ability to provide other central government services.

\(^{78}\) The figure of £1.3 billion is one third of Scotland’s projected North Sea revenue excluding the Orkney and Shetland islands.
Table 4 shows three scenarios for the change in the UK fiscal balance due to Scotland’s departure. The numbers refer to the fiscal year 2015-16. The first line is the baseline change which is taken directly from table 2, with the sign reversed. In all three scenarios, following the departure of Scotland, the UK continues to spend approximately 80 percent of the amount notionally allocated to Scotland in the official accounts for non-identifiable expenditures, excluding interest payments. This reduces the expenditure savings when Scotland leaves by £5 billion. The scenarios differ in their assumptions about interest and North Sea revenue.

Note that the adjustments for interest and North Sea revenue in table 4 are the mirror image of those shown for Scotland in table 3. For example, if there is a reduction in Scotland’s North Sea revenue due to lower oil prices, the fiscal effect is denoted by a minus sign in table 3 and a plus sign in table 4. The plus sign indicates that, if oil prices are low, Scotland’s departure implies a smaller loss of North Sea revenue for the UK than if oil prices are high. Note also that the labelling of scenarios is reversed. The worst case scenario for the UK is the best case scenario for Scotland and vice-versa.

Table 4. The Impact of Scottish Independence on the UK Net Fiscal Balance: 2015-2016

<table>
<thead>
<tr>
<th>Alternative Scenarios</th>
<th>Intermediate Scenario</th>
<th>Worst Case Scenario</th>
<th>Best Case Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baseline change in balance (= minus line (7) of table 2)</td>
<td>+7.8</td>
<td>+7.8</td>
<td>+7.8</td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Defence and other non-identifiable expenditure</td>
<td>-5.0</td>
<td>-5.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>Interest payments</td>
<td>0.0</td>
<td>-5.1</td>
<td>0.0</td>
</tr>
<tr>
<td>North Sea revenue:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Orkneys &amp; Shetlands</td>
<td>0.0</td>
<td>0.0</td>
<td>+1.5</td>
</tr>
<tr>
<td>Production &amp; prices</td>
<td>-2.6</td>
<td>-2.6</td>
<td>+1.3</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>-7.6</td>
<td>-12.7</td>
<td>-2.2</td>
</tr>
<tr>
<td>Final change in balance</td>
<td>+0.2</td>
<td>-4.9</td>
<td>+5.6</td>
</tr>
<tr>
<td>% UK GDP</td>
<td>+0.0</td>
<td>-0.3</td>
<td>+0.3</td>
</tr>
</tbody>
</table>

The worst case scenario (from the UK point of view) makes the following assumptions:

- **Interest**: The nationalists accept no responsibility for Scotland’s share of the national debt and related interest payments. This reduces the annual savings to the UK resulting from Scotland’s departure by £5.1 billion.
- **Orkneys and Shetlands**: These islands leave the UK to become part of an independent Scotland, No adjustment to the baseline scenario in table 2 is therefore required.
- **Prices and production**: Hydrocarbon prices and production remain buoyant. As a result, the UK loses more North Sea revenue when Scotland leaves than is envisaged under the baseline scenario. The additional loss is £2.6 billion, which is equal the gain to an
independent Scotland from higher hydrocarbon prices and production as shown in table 3.

Under this scenario, the change in the UK net fiscal balance due to Scotland’s departure is -£4.9 billion or -0.3 percent of GDP.

The best case scenario (from the UK point of view), makes the following assumptions:

- **Interest**: The nationalists accept full responsibility for Scotland’s share of the national debt and related interest payments. No adjustment to the baseline scenario in table 2 is therefore required.
- **Orkneys and Shetlands**: These islands remain in the UK along with the rest of Scotland. This reduces Scotland’s entitlement to North Sea revenue by 30 percent. The resulting gain to the post-independence UK is £1.5 billion.
- **Prices and production**: Hydrocarbon prices and production are lower than envisaged under the baseline scenario. As a result, the UK loses less North Sea revenue when Scotland leaves than the baseline assumes. To allow for this, we adjust the UK fiscal balance by +£1.3 billion.

Under this scenario, the UK net fiscal balance improves by £5.6 billion or 0.3 percent of GDP following Scottish independence.

There is also an intermediate scenario in which Scotland accepts responsibility for its per capita share of the UK national debt, but North Sea revenue remains buoyant because of high hydrocarbon prices and the Orkneys and Shetlands remain in the Scottish fold. In this scenario, the departure of Scotland has virtually no impact on the UK fiscal balance. This is probably the most realistic scenario.

The above scenarios indicate how little effect Scotland’s departure has on the UK fiscal balance as a proportion of GDP. Even in the worst case scenario, the net impact on the UK fiscal balance is only -0.3 percent of GDP. Under the best case scenario the gain is 0.3 percent of GDP. The gain in the latter case would be somewhat larger, were it not for the fact that the UK continues spending almost as much on defence and other central government services as it did before Scotland’s departure. From a UK fiscal point of view, Scottish independence is almost a non-event. This is not necessarily the case for Scotland, where under certain conditions the country is left with a fiscal deficit which is large in relation to its small economy.

**Concluding Remarks**

In projecting what would happen to government finances in the event of Scottish independence, the greatest area of uncertainty is North Sea revenue. In the case of North Sea revenue, there might be scope for some haggling over the precise boundaries of Scotland’s exclusive economic zone, but these would be largely determined by established principles of international law. The main geographical uncertainty concerns the Orkneys and Shetlands which might opt to remain in the UK in the event of an overall ‘yes’ vote for Scottish independence. There is also uncertainty about the future behaviour of oil and gas prices. They are currently at a high level but could rise still further in response to world economic and political events. Or they could fall sharply as they did in late 2008, although this seems unlikely. A durable reduction in oil and gas prices would accelerate the decline in
North Sea hydrocarbon production, thereby reinforcing the decline in revenue from this source. There is also some uncertainty about debt and interest payments. Given its importance to an independent Scotland, it would be rational for the nationalists to seek to minimise their country’s responsibility for the UK national debt.

The direct fiscal impact of Scotland’s departure on the rest of the UK would be small in relation to UK GDP. There are also dynamic effects to consider. In the worst case scenario, an independent Scotland might find itself burdened with debt, with a large fiscal deficit and compelled to implement another round of austerity in addition to the period of austerity already experienced within the UK. This would damage economic growth in Scotland and have knock-on effects on the rest of the UK. In extremis, the UK might have to step in to help bail out Scotland just as it is currently helping to bail out Ireland. At the other extreme, given buoyant revenue from the North Sea, or perhaps some relief from its potential debt and interest burden, Scotland’s fiscal deficit would be manageable and the country would not require external support. A prosperous Scotland would be a valuable trading partner for the rest of the UK, although it would also be a competitor.

1 May 2012
Q188 The Chairman: Good afternoon, Professor Rowthorn, and thank you very much for coming. This is the fourth public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. We are very grateful to you not only for coming but for the excellent paper that you provided to the Committee. It covers a lot of ground. I would like to start by asking a fairly general question. You have already covered some of the points in your paper, but this is to get the discussion going. If Scotland becomes independent from the rest of the United Kingdom, how will the UK’s stock of assets and liabilities be divided up? As I said, I know that you have gone into some detail on this in your paper, but could you give a brief summary and tell us which you regard as the most important to consider from the economic point of view?

Professor Rowthorn: One of the biggest is the so-called national debt—it is actually public sector net debt. If Scotland had its per capita share and in a few years’ time there was a referendum saying yes, then in 2016-17 Scotland’s share of the debt would be about £120 billion. I think that would be the biggest item. You can go on to things like pension liabilities
but the way those are calculated for the Government discounts all possible future pension obligations back to the present, which for the UK at the moment are about £5,000 billion or that kind of figure. Those are rather meaningless figures because they imply what the obligations will be for annual payments in future. I do not think that that would be a terribly important item because, if Scotland became independent, broadly speaking and with some fiddling at the margins, it would take responsibility for people living in Scotland and we would take responsibility for people living in the rest of the country. There might be some arguments about particular pension arrangements but that does not seem a very big item in comparison with the so-called national debt. That is the biggest item.

The other question is the liabilities of the Royal Bank of Scotland and Lloyds—that is, the Bank of Scotland. Those liabilities are huge, but the figures are misleading because they do not take into account the assets. Most of those assets are not liquid. The extended national debt including the financial sector is defined as financial liabilities minus liquid assets. Most of the assets of a bank are not liquid in that sense. The bank may have very good assets but they are not liquid so it gives a misleading impression. If you lay off assets against liabilities, I do not think there is a very big difference. So I do not think that that is, in aggregate terms, such a big figure. Of course, the issue is still the liabilities because if a bank got into serious trouble it might be called upon to cover these liabilities. The contingency might arise that you had to do something about them. The future of the banking system is quite an important issue. I do not think it is best seen as simply a division of assets. One has to think more of the implications for the banking system. Banks are not only international but also span the whole of the UK. For example, RBS has National Westminster Bank as a subsidiary which operates mainly in the rest of the UK. You would have to consider that. That is a more complex issue than simply who takes control of what as assets in a purely simple, financial sense.

There are other assets of course, such as military assets and that kind of thing.

Q189 The Chairman: Starting with the UK national debt, how would you see it apportioned and how would that be achieved in practice? Dealing with the national debt and the Royal Bank of Scotland, would you expect Scotland to take a proportionate share across all maturities of debt instruments? Would that run the risk of having too illiquid markets at some maturities? Over what timescale would that be dealt with?

Professor Rowthorn: I have to be frank that I had not thought of the issue of maturity. I had thought of it in aggregate terms because Alex Salmond said that Scotland would take a proportionate share. He mentioned per capita share. When Ireland became independent, it was stated that Ireland would take responsibility for its proportionate share. I am not sure whether that meant that they accepted the debts or the servicing on the debts. One possibility would be that they remain UK debts but Scotland would accept responsibility for servicing them and retiring them as they reached maturity.

The Chairman: So there are a lot of complications in achieving the divisions in practice.

Professor Rowthorn: There certainly are. I think the negotiations would last quite a long time.

Q190 The Chairman: I also want to ask how you would deal with the Royal Bank of Scotland issues and others. Who would be responsible and how do you share out any net loss that has occurred in supporting the UK banking sector?

Professor Rowthorn: Well, that is a difficult question, depending on whether you mean a net loss taking into account what has already been spent on these banks or taking into account net loss in the future if we start from this moment.
The Chairman: Start from the first of those.

Professor Rowthorn: Well, if we take the second one, it is not clear that there will be any loss. In other words, there might be a net profit. But if you look to the past, how would you divide that? Some people say that maybe Scotland should take it all because it is a Scottish bank. The alternative argument is that it is a bank that serves the whole of the UK and we should share it more equally. I think that that is the SNP argument. Personally, in that sense of looking at the past, I take a per capita view. It would be reasonable to say that the money that has already been spent should be divided on a per capita basis.

Q191 Lord Lawson of Blaby: If I may go back to the public or national debt, or whatever you like to call it, do you think there is some clear and objective way of apportioning it, or is this a matter of almost infinite possibility for dispute and argument? Secondly, if it is the latter, do you think that this should be sorted out in advance so that everybody knows what they are voting for or against, or do you think it should be left until after the event? If so, there might then be a decision made in principle for Scottish independence but nobody would know what it meant economically. There would then be a long period of perhaps rather acrimonious negotiation before an agreement was reached.

Professor Rowthorn: Generally speaking, it is a good thing in both a democracy and commercial life to know what you are buying and what you are paying for it. It would be good if this was all sorted out in advance. Realistically, I think people will discuss the alternative possibilities but it is unlikely that any of the parties would agree in advance what the outcome would be.

Q192 Lord Lawson of Blaby: I am sorry to ask a double-barrelled question which always complicates things, but my first question was: to your knowledge is there any generally agreed way of splitting the public or national debt?

Professor Rowthorn: There is not an agreed way but per capita is the way most used. In the national accounts, unidentifiable expenditure is typically divided by allocation to different parts of the country or to Scotland on a per capita basis. That is not an unreasonable way to do it but it is done that way because people cannot think of an alternative. It is very simple and has some intuitive explanation for it. An alternative might be to do it in proportion to gross domestic product, but would Scotland’s gross domestic product include most of the oil revenue or not? If you do not include the oil revenue, that would be very similar to per capita. Excluding oil, per capita GDP for Scotland is very similar to the UK average. So that would not make much difference.

Q193 The Chairman: You make clear in your excellent paper how significant the issue of North Sea oil revenue is. That comes up very clearly in your different scenarios. It is a very significant element. Of course, the point behind this is whether Orkney and Shetland decide to stay with the United Kingdom. Do you have any feel as to whether there is a realistic possibility of that happening?

Professor Rowthorn: I have no idea at all. I read a paper by the two MSPs for Orkney and Shetland and it implied that they might stay in the United Kingdom. That would be about the extent of my knowledge of it. I am not sure, to be honest. They make noises periodically about it. I understand that they did not want devolution, but I do not know.

Q194 Lord Hollick: The financial services sector is quite important to the Scottish economy. Have you given any thought to the benefit or opposite of having a major international bank headquartered in Scotland? It would be entirely feasible to split out, let us
say, the Scottish part of RBS. A lot of the international activity carried on outside of Scotland, where a lot of the problems arose, is based in London. It does not create many jobs in Scotland. Have you or anybody else probed into the importance of having banks headquartered in Scotland? That brings with it the significant liabilities which may not all yet have been recognised on the balance sheet.

Professor Rowthorn: If you take Lloyds Banking Group, I think its headquarters are in London but its registered office is in Scotland—it is the same registered office as the Bank of Scotland, which is part of Lloyds. I am not sure what the legal status is of that, to be honest. If it carried on like that after independence, I do not know whether Scotland or we would be responsible. I have a feeling it would be Scotland. The point is that if the headquarters are in Scotland it may expose Scotland to quite serious problems. However, if a bank spans the whole of the United Kingdom, then no matter what the legal position is, if something goes seriously wrong with this bank it may affect us quite a lot. It is like the Spanish banks, for example. Technically speaking, Spain is responsible for them but the rest of Europe is bailing them out because they have implications elsewhere. That may not be so important. Personally, I think a rational solution would be to break up the Royal Bank of Scotland and Lloyds by hiving off the Scottish parts separately. That is quite a rational solution, I think.

Lord Hollick: That would be consistent with the sort of ring-fencing approach that has been envisaged by Vickers.

Professor Rowthorn: Yes.

Q195 Lord Lipsey: If I could go back to where the Chairman started, on oil revenues and their volatility, I did not get from the paper a sense of what the model is for oil prices. If oil prices halve, for example, does that mean that you get half as much oil or that nobody bothers to dig any out at all? Is it a very hair-trigger mechanism or relatively smooth, where as the price goes up we get somewhat more?

Professor Rowthorn: Basically, yes. I took the Office for Budget Responsibility projections up to 2017, then took 90% of those and said that was the Scottish share. Then I considered what would happen if you somewhat increased or reduced that. The point is that the relationship between oil prices and revenue is quite complex because it affects exploration activity and production. It is beyond me to make calculations like that. Alex Kemp and Linda Stephen from the University of Aberdeen did simulations of this variety and looked into the effect of different assumptions about the oil price, extraction costs and that kind of thing. They revealed quite a big effect upon the amount of production but there is quite a complex relationship between production and prices because of the costs of production. I looked at various scenarios which were not unreasonable. If you look at the past decade and take the geographical share of oil revenue due to Scotland, it has been between 5% and 10% of Scottish non-oil GDP. My so-called intermediate scenario suggests just over 5% whereas the OBR thinks it will go down to about 3%. The OBR is rather pessimistic about production and prices.

Q196 Lord Levene of Portsoken: First, I was going to ask a similar question to Lord Hollick’s about RBS and Lloyds. From memory, when Lloyds bought HBOS it was a political—with a small p—decision to base the office in Scotland because it had taken so much out of Scotland. If you look at both those institutions, I am quite sure that the vast majority of their business, assets and everything else lies outside Scotland. I do not think that the inference that it would actually be down to an independent Scottish Government to take
responsibility for such huge international banks follows at all. Do you have any particular reason for thinking that it should, apart from the name of the bank?

Professor Rowthorn: If the whole thing became legally Scottish then the Scottish government might feel that they needed to take responsibility. They do not have to. The Irish Government’s decision essentially to take responsibility for the liabilities of Irish banks was not one that they had to take—and they shot themselves in the foot with that.

Q197 Lord Levene of Portsoken: When you say that they became “legally Scottish”, all that actually happened was that the head office was based in Scotland. I do not think that that would necessarily mean that the Scottish Government had responsibilities for them. I cannot see a large company that was not a bank but happened to be headquartered in Scotland turning to the Government when something went wrong and saying, “All right, you pick up all the pieces”. That is a non sequitur.

Professor Rowthorn: No, I do not think that the Government has to pick up the pieces. That is right. The point is that the Government have some legal powers in terms of what they can do to the banks. That is the point.

Q198 Lord Forsyth of Drumlean: Sorry, I come from exactly 180 degrees opposite to the point of view of Lord Levene. It seems that both the Royal Bank and that bit of Lloyds/HBOS that is the Bank of Scotland and Lloyds/TSB are headquartered in Scotland and are registered Scottish companies. The Bank of Scotland actually predates the Bank of England and has been in Scotland for more than 400 years. Indeed, the headquarters of the Royal Bank of Scotland in Edinburgh, which were opened by the Queen, are a splendid thing to see. So although the business may not necessarily be done in Scotland, the business has been centred in Scotland and is very much built into the whole psyche and nature of Scotland. My question is: in an independent Scotland, assuming that people would still wish to have these important financial institutions in Scotland—I certainly would—is it a practical proposition that such banks could operate, given the size of the economy and the likely credit rating that an independent Scotland would have?

Professor Rowthorn: Well, in terms of Lloyds, the point is that the Bank of Scotland is a bit separate. The Bank of Scotland is not only the oldest bank but it is one of the three banks issuing Scottish notes. I think that the Bank of Scotland operates independently in Scotland but the Halifax does not, so it would be feasible to have the Bank of Scotland hived off as a separate bank in Scotland. I am not sure how you would divide up RBS.

Q199 Lord Forsyth of Drumlean: I am thinking of the Governor of the Bank of England’s point. He argued for breaking up the banks and that, relative to the size of our economy, the banks’ balance sheets have been too large. My question is really whether it would be practical for an organisation the size of the Royal Bank of Scotland, or even the Bank of Scotland, to operate in an independent Scotland given the systemic risk that they would represent to the Scottish economy. Also, given the nature of the Scottish economy, would it find that the cost of doing business in Scotland made it less competitive?

Professor Rowthorn: The short answer is that I do not know.

Lord Forsyth of Drumlean: I do not know either.

The Chairman: We might be able to put that question to other witnesses.

Professor Rowthorn: I might come back to it in the course of time.
Q200 Lord Forsyth of Drumlean: Yes, please do, if you have some thoughts on it. The other question is about the apportionment of the debt, which the Chairman raised. Why is it right to assume that it should be done on a per capita basis? Given that the debt has grown substantially, particularly in recent years because we have been spending more than our income, and that Scotland benefits under the Barnett formula by about 20% more per capita than England, why would it not be appropriate to look at the share of the debt in relation to the share of the expenditure that has been enjoyed?

Professor Rowthorn: As a Welshman of unionist persuasion, I am sympathetic to this argument but it must be said that one argument for the Scottish nationalists is that if Scotland had been an independent country and had had the oil it would not have had a deficit. Consequently, the extra expenditure in Scotland would have been financed not by transfers from England—which is what happens; it is not from the UK but from England—but by “Scottish” oil.

Q201 Lord Forsyth of Drumlean: Do you accept that argument?

Professor Rowthorn: No, I am not saying I accept it. The point is that it is very difficult in these things to decide who the oil genuinely belongs to, if you see what I mean. There are different views of that and of who is entitled to the transfers. The fiscal union argument would be that you live in a fiscal union as a single state and are entitled to the transfers simply because of the fiscal union. The other argument is of course that the Barnett formula gives Scotland above average expenditures so that the fiscal transfer is above what would, say, be given to Wales. I agree that the Barnett formula applies but it is above what is given to Wales or to the north-east for that reason. You can argue that it could be on the basis of expenditure in the past but it is hard to decide what should be in or out of the expenditure. Quite a lot of what is called expenditure in Scotland is actually simple government expenditure that is allocated to Scotland on a purely per capita basis—as it is with every other part of the UK. For example, military expenditure in the Scottish accounts is simply Scotland’s per capita share of total UK military expenditure, so quite a lot of expenditure items are already done on a per capita basis. It is quite hard to decide what the true, extra expenditure of Scotland is over the rest of the UK. You can do it but it is not such a simple approach as the per capita approach, which has the great advantage of being extremely simple.

The Chairman: We will come on to the Barnett formula in a moment. Lord Rowe-Beddoe?

Q202 Lord Rowe-Beddoe: Can I go back to the national debt? Is there anything we can gain by looking backwards and reviewing the experience of Czechoslovakia?

Professor Rowthorn: Do you mean when it broke up into two parts? When Czechoslovakia broke up, they formed a monetary union and promised to use the common currency for six months. I believe that they broke up in five weeks. Then Slovakia devalued, its economy improved and they could not really agree. Other monetary unions have broken up. The Scandinavian monetary union broke up because they came off the gold standard at the beginning of the First World War as they faced different economic circumstances. The First World War affected the three countries there differently. Once it affected them differently, they broke up the monetary union. I think that that would be one of the problems if there was a common currency between the rest of the UK and Scotland: there might be asymmetric shocks. In other words, the Scottish economy might perform very differently from the rest of the UK, in which case it might be beneficial to devalue or the opposite. We
have seen this in the European Union and the same issues apply. I have to say that I do not think that the differences between Scotland and the rest of the UK are similar in character or scale to those between Greece and the rest of the European Union.

Q203 Lord Rowe-Beddoe: To go back to Czechoslovakia for a moment please, take it forward for me. As I understand and as mentioned in your paper, Mr Salmond is advocating that he would maintain sterling for the future. What do you think would be the position of the UK Government in that event?

Professor Rowthorn: Well, the UK Government could not do anything about Scotland’s decision to maintain sterling. I heard a radio programme the other day in which several people said that Scotland could not use sterling without the permission of the UK. That is rubbish and completely false. For example, Ecuador dollarised its economy in 2000. You go to Ecuador now and everything is done with dollar bills. They are not Ecuadorian money with “dollar” on them but American dollar bills. The same is true in El Salvador, East Timor and Panama—it has been true there for 100 years. Ecuador did that unilaterally. There is no way that the United Kingdom could stop Scotland using the pound sterling. On the other hand, that does not mean that the central bank of Scotland—or whatever it would be—could print £20 UK notes. That would be counterfeiting.

Q204 Lord Tugendhat: The questions you have been asked have tended to be about what the effect on Scotland would be. In the event of Scottish independence and the Scots continuing to use the pound—which you say they will—would it be in the interests of the rest of the UK or the successor state to have Scottish representation on the Monetary Policy Committee? There was a certain amount of trouble in the Scottish Parliament last week when Nicola Sturgeon said that Scotland would have a member there. Presumably, it would only have a member if the UK Government and the Bank of England agreed that it should. Do you think it would be in the interests of the UK Government and the Bank of England to have a Scottish member or would this be something of benefit to Scotland? Where do you think the benefits lie?

Professor Rowthorn: It is difficult to say. It would give Scotland a voice but it might be a disadvantage because it might not be able to act independently and complain about decisions made by the committee of which it was a member. It is not clear. It is like being a trade union member on the board of a company. It is sometimes better not to be one.

Q205 Lord Lawson of Blaby: It certainly is. I was rung up by the Scottish press just before the Jubilee recess. They asked what I thought about Alex Salmond and Nicola Sturgeon saying that it does not matter because sterling will be protected and they will have a Scottish member on the Monetary Policy Committee. I said that that was complete nonsense. Do you agree with that? If, as you rightly said, they decided to have sterling as their currency, that is their free and unilateral decision which they are perfectly entitled to make. But that does not give the Bank of England any obligation to have a Scottish member on the Monetary Policy Committee. It would be an extraordinary precedent if on the Monetary Policy Committee of the Bank of England you had a Frenchman, German or anybody who, if they were not a citizen of the United Kingdom—the committee relies on some Americans—somehow represented another country or foreign power.

Professor Rowthorn: I agree. There are quite a lot of disadvantages in sharing sterling anyway from the Scottish point of view. One is that Scotland would lose the right of seigniorage. Governments can create money and finance their expenditure by doing so, but Scotland would not be able to do that and we could do it at Scotland’s expense. As Scotland
grows larger and needs more pounds, we could print them and get the benefit. That is one side of it. The other thing is that we would not automatically be a lender of last resort for Scotland, whereas we would be within our own boundaries. Those are quite big losses. There are advantages in having a single currency, but there are quite big losses, too.

Q206 Lord Lawson of Blaby: Weighing up these advantages, broadly speaking, there are three possibilities—with refinements of the three. Scotland would either have the pound, the euro or the Scottish groat. If you were an adviser to an independent Scottish Government, which of those three would you advise them to have?

Professor Rowthorn: They could also use the policy used in Vietnam and a number of countries, so that sterling circulated alongside the Scottish currency. Scottish currency would be legal tender in Scotland so that, for example, Government payments would be made in it. On the other hand, people would also use sterling extensively. That is quite possible. It happens in some countries like Denmark, where people use the euro quite a lot in ordinary exchange. If Scotland has its own currency, the question is whether it would want to tie that to the pound. For example, the Danes shadow the euro—at least I think they do; they did for a long time. Would Scotland want to do that? There are some advantages in having its own currency. If it got a big shock to its economy—positive or negative—that was different to the shock to the rest of the UK, it could alter the exchange rate. You can see that Greece would have been much better off if it had had its own currency. I am not saying that that would have solved its problems but it would have been better off. Sterling is probably the simplest currency because Scotland trades on such a large scale with the UK.

Q207 Lord Levene of Portsoken: Briefly, I will ask what might be a stupid question. Scottish banks issue currency today, albeit that they are pounds. I am speaking from ignorance, but I presume that those are issued at the end of the day under the authority of the Bank of England.

Professor Rowthorn: They are. The point is that the Scottish banks effectively operate like a currency board in the sense that they issue Scottish notes—£5 and £10 notes etc—and they must have an equivalent amount of sterling deposited at the Bank of England. Essentially, they are just like a currency board. They cannot issue what they have not already got deposited.

Q208 Lord Forsyth of Drumlean: Are you suggesting that that would end?

Professor Rowthorn: They could decide to use a currency board arrangement, so that they would have Scottish notes but which would be one-for-one exchangeable with British ones. They could do that but it is not clear why they would want to. The simplest thing would be for them to use sterling but that gives rise to the problems we are talking about.

Q209 Lord Forsyth of Drumlean: So they would still be able to issue their own bank notes? They would still be able to have Alex Salmond on the note if they wanted, or Robert the Bruce or Walter Scott?

Professor Rowthorn: Yes, I think they would.

The Chairman: We have covered a pretty wide field but we will try to probe some more of these areas in depth. Lord Lawson will move us on to the next topic.

Q210 Lord Lawson of Blaby: Let us get on to public expenditure. You made a reference to there being a kind of trade-off. Okay, the Scots get more than their fair share as
it were of UK public expenditure under the Barnett formula. That unfairness was established by a report made a year or two years ago by a Select Committee of this House and it happened for accidental reasons. Population trends did not go the way that was expected and there were time lags in the system so that it was not adjusted. In the mean time, there was base drift and all those things. That was all set out in the report and I do not think that these are matters of controversy. Of course, it has been politically sensitive to alter it so it has not hitherto been altered but that is how it is. You said that there is a trade-off against the fact that Scotland has all the tax revenues from North Sea oil, or “Scottish” oil. I think we need to separate out these two issues. I would like to focus just on the public expenditure. Scotland has much higher public spending per head of population than the rest of the United Kingdom. It also of course gets this excess that was not intended when the Barnett formula was first founded as a way of stopping the annual haggling. That was why it was done but Scotland gets more than its fair share that way, unlike your country of Wales, which if anything gets less than its fair share. What do you think will happen as a result of independence? Presumably, the Barnett formula and all the sharing of public expenditure would disappear. An independent Scottish Government would decide the level of public expenditure and what it was spent on, quite separately from the rest of the United Kingdom. Those would be separated out.

If I may put another issue that relates to that, you talked about a fiscal union. Of course, a fiscal union—though it is a political union as well—operates largely not by these kind of discretionary Barnett transfers but by the fact that automatically it is the wealthier parts of the union that generate most taxation and the poorer parts who receive most benefits. I am oversimplifying but that is basically right. It is not done on the basis of geography. However, that would all change, too, if there was no longer the union. Where would it all come out and what would be the consequences of independence for Scotland as far as public expenditure is concerned?

**Professor Rowthorn:** I guess that if Scotland had reasonably high oil revenue there would not be much change because that would roughly offset the transfers that it gets under the Barnett formula.

**Q211 Lord Lawson of Blaby:** You are saying that they would be able afford it. Why?

**Professor Rowthorn:** The politics of Scotland is that great resentment has been stoked up against Westminster for public expenditure cuts et cetera. It might be that there would be a lot of pressure in an independent Scotland for increased public expenditure for which there was not the cash unless oil prices were very high. If they were high, that would be different. Basically, “You are on your own now” would seem to be the logic of it and, “If you can pay for it, you can pay for it and if you cannot, you cannot”. Fiscal transfers would stop. If there were enough oil revenue then that would be okay; if there were not very much oil revenue then there would be a bit of trouble.

**Q212 Lord Forsyth of Drumlean:** Can I just ask you about the costs that might occur because an independent Scotland would have to duplicate services and institutions? For example, presumably there would have to be a financial regulator to deal with banks, insurance companies and so on, and a debt management office. Have you any idea of what that might be likely to cost and what the implications might be for the overall fiscal position?

**Professor Rowthorn:** I do not really know. The only thing that I really paid attention to in the paper I gave was an assumption about non-military costs. If you put aside the non-military side and the defence spending, there is a substantial body of what are called non-
identified expenditures for the UK as a whole. Those serve everybody in the UK to various degrees but it is not easy to identify how much. I just assumed that Scotland's per capita share of those would continue. Mostly in the national accounts, Scotland is assigned its per capita share and I assumed that that would continue. It is quite a large amount of money and I would be surprised if the kinds of things that you are talking about were not covered by that. That is all that I assumed and I could not put a price upon what it would cost to run the Scottish tax system or something like that. A fair amount of administration is already done in Scotland. For example, you would not have the cost of running another Parliament because Scotland already has one. The military side is quite an interesting one.

**Lord Forsyth of Drumlean:** Scotland has not got a financial regulator or a debt management office.

**Professor Rowthorn:** It does not, but the cost of those things is pretty small in comparison to the total GDP. A few million a year in this context is nothing. To us, of course, it is a lot of money but spread against the total Scottish GDP it is not.

**Lord Forsyth of Drumlean:** Spread across five million people in Scotland it is not insignificant.

**Professor Rowthorn:** The military one is more interesting, I think.

**Q213 Lord Forsyth of Drumlean:** There is also the cost of changing the arrangements. For example, if Scotland wants to get rid of its nuclear deterrent, the costs of moving the nuclear deterrent would arise because of its policy. Who would be responsible for that?

**Professor Rowthorn:** Exactly. Maybe the deterrent could be made unworkable by blockading it. That is not entirely clear. The interesting thing is that I just assumed that Scotland would spend on defence roughly what Denmark spends. That is roughly about 1.6% of GDP. That is less than we spend proportionately but it is something like Denmark. It would not be as much as Norway because Norway is a richer country—richer even than Scotland would be. It would be something like that. Of course, that ignores transitional costs. There are transitional costs for the UK. It is not just whether we would move the nuclear submarines but where we would move them to. Also, there is the transitional cost to Scotland. For example, would it take over part of our military equipment? Would we give Scotland some of our planes and what would it do for pilots, or something like that? Would it have to start from scratch and buy a completely new set? We could say that we still need our pilots and equipment, and move them to some base in the rest of the UK. These are quite important issues, but I am not sure what the financial implications are.

**Q214 Lord Levene of Portsoken:** In the different scenarios you sketch out, you show a large range of estimates for an independent Scotland’s fiscal balance. How important is the volatility of deficits relative to those levels? If the division of the UK assets and liabilities follows your main scenario, what do you think would be an upper range for Scotland’s fiscal deficit? Are there any ways in which that volatility could be managed?

**Professor Rowthorn:** As I said, the range depends on what happens to oil revenues. I would be surprised if they were less that 2% of GDP and they could rise to 6% or 7%. You are talking about big uncertainty here, some 4% or 5% of GDP. There are two issues. One is the volatility, where the question is that of medium-term trends; the other is long-term trends, too, but nobody knows those. If you look at oil prices over the past 25 or 30 years, Brent crude oil was trading at $25 per barrel up until the early 2000s. It then rose to $150, dropped to under $50, rose again to $115 and is now down to $100. Those are quite big variations and the OBR estimates assume that it will go down to about $95 per barrel.
There is a lot of uncertainty in that. The range could be about 4% of GDP, top to bottom, or even 5%. Those are big figures, and they are much more important if they are permanent rather than if they are just for one year. The problem with oil price variations is deciding whether they are temporary changes or permanent ones.

Lord Levene of Portsoken: They move very quickly.

Q215 The Chairman: The other point that you bring out clearly in your paper is that the size of the possible implications of such volatility is much greater for Scotland, being a small country, than it is for the rest of the UK.

Professor Rowthorn: Yes, I think that the great uncertainty of that is one of the major arguments against Scottish independence. It could be a great success, from Scotland’s point of view, if oil were to remain very expensive for quite a long time. But it must be said that if you look over the 25 or 30-year perspective, Scottish oil revenues will decline almost whatever happens to the price of oil. One should not take too short-term a perspective. Of course, in electoral or referendum politics, the current price of oil might play quite a big role. When it is high, the SNP will say, “Look, there is plenty of money for us”, and anyone who says that it will fall in the future will be accused of being a pessimist. The SNP will imply that really it will stay high almost indefinitely.

Q216 Lord Lawson of Blaby: You are absolutely right that the volatility is a very important dimension in this. Even if the SNP says that it thinks prices will remain high or go even higher, the financial markets are unlikely to take that view. Presumably, there would be some excess rate of interest that the Scottish public debt would have to pay because the financial markets were concerned about this volatility. Would you not agree?

Professor Rowthorn: Yes, I agree. The fact that Scotland is small is in itself not so important because some of the lowest interest rates, yields and 10-year bonds are in small countries like Denmark, Finland, Sweden and Switzerland. But none of those has an asset as volatile as oil.

Q217 Lord Lawson of Blaby: Of course, these countries and particularly Switzerland have a pretty good track record over a large number of years, which an independent Scotland might acquire. One hopes that it would, but initially it would not have that track record and would not be seen in the same light as them. That would be another factor.

Professor Rowthorn: Can I just come back on that? It is a bit like when Labour got into power in 1997. It had to set up the independent Monetary Policy Committee as a sign to the markets that it would be responsible. The SNP would have to do something of the kind to indicate its reliability to international markets.

Q218 Lord Lawson of Blaby: That is a very good point. It is interesting to speculate on what it might do that would carry that confidence. May I ask you about one interesting assertion in the excellent paper that you provided for us? The rest of it is quite clear but I am not quite clear what you are saying when you point out that, on the projections that you have made based on official figures, the Scottish public deficit would decline far more slowly than the public deficit of the rest of the United Kingdom. Then you say that, “The slow pace of decline in Scotland’s deficit is partly due to the assumed behaviour of North Sea revenue … This development is explained in part by a combination of falling production and falling prices for North Sea hydrocarbons from 2012-13 onwards”. If it is only partly explained by this, what is the rest of the explanation?
**Professor Rowthorn:** If you multiply the price changes by the quantity changes, you do not get the estimated change in revenues. The difference may well reflect changes in the tax regime or alternatively the assumed cost of production for oil. In other words, the revenue from oil and gas is not just price times quantity; you also have to take into account the cost of production and the tax regime. All the OBR gives is the information on the prices and quantities. It gives the assumed prices and assumed quantities of oil and gas, and the assumed revenue. What you see is that the price and the quantity fall, but they do not seem enough in themselves to account for the fall in revenue. There is something else going on there and that has either got to be the tax regime or the cost of production.

**Lord Lawson of Blaby:** You have not asked the OBR what it is.

**Professor Rowthorn:** No.

**Q219 Lord Forsyth of Drumlean:** Quickly on this point, to simplify it, are we saying that a Scottish Government faced with oil being such a large part of their income would get a double whammy: if the oil price falls and they have to meet their public expenditure obligations they would have to borrow, but because the oil price was falling and because of the volatility of the oil price, they might end up having to pay more in interest rates to finance that borrowing?

**Professor Rowthorn:** If they had a record for being very reliable in a fiscal sense, as a place such as Denmark has, that would not be the case. If it was a short-term volatility, it would be assumed that they would do something about it. If the price of oil fell and remained low for some years and they experienced serious fiscal problems with maybe conflict at home about them—not riots in the streets but some political instability—then they would have to pay a lot higher interest rates.

**Q220 Lord McFall of Alcluith:** You mentioned the need for the SNP to make a gesture to the international markets regarding reliability. If the gesture was tied to sterling with an agreement with the Monetary Policy Committee of the Bank of England, what degree of latitude do you think an independent Scotland would have in monitoring fiscal policy?

**Professor Rowthorn:** Probably not very much. It might have independence with regard to what its tax rates would be, for example who it would levy taxes on and whether it would have a lower corporation tax or a higher income tax et cetera. But in terms of fiscal deficit, broadly speaking it would have rather severe limits on what it could do.

**Q221 Lord McFall of Alcluith:** In terms of taxation, do you expect an independent Scotland to introduce different corporation and personal tax rates compared to those in the United Kingdom, and how feasible is that within the EU?

**Professor Rowthorn:** I think that, legally speaking, within the EU it can bring in different corporation taxes. I think that under EU law you cannot introduce them for single regions like the north-east unless they have some form of autonomous local government.

**Q222 Lord Lawson of Blaby:** But that goes back to something said earlier. We know that the European Union is very unhappy about and putting huge pressure on Ireland not to have a low corporation tax rate. It would perhaps be afraid that an independent Scotland might do the same. Before allowing an independent Scotland to join the European Union, which is discretionary not automatic in law, it would presumably require certain undertakings on the tax front, would it not?
Professor Rowthorn: What is legal and what is political are not necessarily the same thing. I quite agree with you. Also, it may be the case that Scotland stayed outside in the European Economic Area. Scotland might have sanctions against it if it pursued a very low corporation tax regime. The EU is a very powerful body and would not be above using its powers, not least on non-EU members if necessary.

Q223 Lord Tugendhat: I notice that the Scottish Government have proposed getting rid of council tax and will have a new property tax. Rather than thinking in terms of different rates of corporation and personal tax, to what extent do they have scope to introduce completely different types of tax?

Professor Rowthorn: Quite a lot, I think. There have been discussions about that in Wales.

Lord Tugendhat: I would have thought that that was more likely.

Professor Rowthorn: The question is about how much more revenue they will raise. The issue is that you may think one tax is more just or efficient than another, but it may not raise more revenue.

Q224 Lord McFall of Alcluith: I was coming on to that. Do you envisage that there would be sufficient capacity in the budget to introduce substantial changes in tax rates? Does Scotland really have the choice between higher public spending and taxes along the Scandinavian model and lower public spending and taxes along the model that Ireland pursued before the crisis?

Professor Rowthorn: In a sense, we are back to oil again—we always come back to oil in the case of Scotland. If the oil revenue is very high, it has a fair scope for doing things and if oil revenue is low it might be tempted to increase taxes at the top rate. Here, 45% is the top rate of income tax. I think the highest in Scandinavia is 50%. Scotland might go up to that but could not go much more.

Q225 Lord McFall of Alcluith: Devo-max is a concept that I do not understand but I am still asking the question on it. I presume that you understand what devo-max means. If devo-max was pursued, how would you expect the competing wishes for fiscal autonomy and avoiding potentially damaging tax competition to be balanced?

Professor Rowthorn: I do not know. On something like corporation tax, you would have some agreement that devo-max was not as max as it might appear. Basically, there would be agreement that there were some areas where competition would not take place. As I said, it would be by agreement, but in practice that agreement would have to be broadly on UK terms.

Q226 Lord Rowe-Beddoe: Following on from the exchange between Lord Forsyth and yourself, an independent Scotland would no doubt have to borrow. It would therefore have to issue its own debt. Do you expect that that would be at a higher rate than that currently experienced by the United Kingdom?

Professor Rowthorn: There are two things here, but the main one is credibility. The big problem is that you would get a new Government which has had a politics of criticising Westminster for not spending enough. That is the name of the game, especially with Conservative Governments. It probably all began in the 1980s. There is a long resentment in Scotland especially towards Conservative Governments, whether rightly or wrongly, and towards Westminster in general. I think there is an expectation that independence would lead to more expenditure and some extra revenue. If there were revenue from oil, that
would be okay but if there were problems on that front then of course Scotland would face some fiscal difficulties. An incoming SNP Government would face a transitional period. They might well have to pay a higher interest rate during the transition until they can establish themselves as fiscally responsible in the eyes of the market. It is possible that for some years they would have to pay a higher interest rate.

Q227 Lord Rowe-Beddoe: How would that reflect on the rest of the United Kingdom? With Scotland paying a higher interest rate, would we be able to pay a lower one for our debt?

Professor Rowthorn: I do not think that that would make much difference, to be frank. Scotland is not that big. It is 8% of the UK.

The Chairman: It is the size of the economy, comparatively.

Q228 Lord Hollick: In today's international bond markets, the debt and deficit figures are obviously watched closely. If, for reasons that you have already alluded to, the oil price goes down or the Scottish economy goes off the rails there could be a very severe penalty that Scotland would have to pay. I suppose that the reverse would be the case if everything went swimmingly well, but it is particularly vulnerable to the volatility of oil prices. Two questions flow from that. Would Scotland also be vulnerable to what happened in the rest of the United Kingdom, for instance if our growth rates continued to disappoint and we failed to get our debt down? Could Scotland be adversely affected by that? On the other hand, in the event that Scotland got into difficulties as Ireland did, because of the relationship existing between our countries would it be inevitable that we would have to come to the rescue? Is there an implicit guarantee—that is quite a strong word—or underpinning from south of the border that is a significant economic consideration for the rest of the United Kingdom?

Professor Rowthorn: On the first point, more than two-thirds of Scotland’s exports of goods and services go to the rest of the UK, mainly to England. That is a very large amount, mainly of services. Oddly enough, despite its past, Scotland is not a big manufacturing economy any longer. It is primarily a service-sector economy with very big service exports to the rest of the United Kingdom. Of course, if we grow slowly or not at all for some years, that would act as a drag upon Scotland, but that would only be the case if the EU was growing faster than us. The interesting thing is that exports to the rest of the EU are less than a quarter of those to the rest of the United Kingdom. Scotland is very dependent on what happens here. That is the first thing: there would be a spillover. Conversely, if we do very well, there would be a spillover effect for Scotland. The other side of the coin is the problem that, since we are very interdependent, we might be compelled to intervene to support Scotland if it was in trouble, whether we wanted to or not. From a bargaining point of view, the dependency and weakness of Scotland is a strength for Scotland because we might be compelled to support it in times of trouble.

Q229 Lord Hollick: Does that interdependence—that may be another way of describing it—argue for a degree of fiscal and monetary co-operation, and possibly institutions in place to achieve that, assuming of course that sterling is the currency?

Professor Rowthorn: Yes. It is not clear that co-operation would take the form of a shared committee with decision-making powers. That is not the same as a group which would handle negotiation of the two sides. They would meet together and discuss something, and that is different from having a committee in which they vote and are then all bound by the common outcome. Yes, whatever happens, if there was an independent Scotland we would have to collaborate very closely with it.
Q230  **Lord Forsyth of Drumlean:** Are you saying that an independent Scotland would be too big to fail, as far as England is concerned?

**Professor Rowthorn:** Too big to fail from our point of view but small enough to get into trouble.

**Lord Forsyth of Drumlean:** So it would have a damaging effect.

Q231  **The Chairman:** Given the high proportion of the Scottish economy that is dependent on services, and that some of these service can be equally provided elsewhere and are not fixed to a particular territory in any way, do you not think that one part of this might be that the services would develop further in England?

**Professor Rowthorn:** Of course, one of the arguments against Scottish independence is that a lot of Scottish business might migrate south of the border. People have said this about, for example, the defence industries. That would be particularly true if some preference was given within the framework of EU law—but who knows what the future holds—for supplying the UK armed services with equipment produced in the smaller United Kingdom. Of course we would then buy less from Scotland. The same might apply with services. On the other hand, Scotland has a strong base in what might be called knowledge-based services, which are not just financial services. I am not convinced that they would migrate south of the border.

Q232  **Lord Forsyth of Drumlean:** Could you just develop that too-big-to-fail point from England’s point of view? I can see why, from Scotland’s point of view, England is very important as a market. From England’s point of view, why would Scotland be too big to fail?

**Professor Rowthorn:** Well, it is quite big. If, for example, Scotland had a severe economic crisis and our exports fell by 10% or 20%, that would damage our economy.

**Lord Forsyth of Drumlean:** So we would be faced with the same argument as the Chancellor is putting at the moment about the consequences of the euro.

**Professor Rowthorn:** Yes. It is the logic of interdependence. If two places are very interdependent, what happens in one affects the other. You cannot just wash your hands.

Q233  **Lord Lipsey:** I suppose that if you are an advocate of Scottish independence then you sort of believe that there will be an animal spirits effect and, freed from the imperialism of London or whatever it is, Scottish entrepreneurs will leap up, as they have at times in the past, and create a much faster growing economy. Is there any evidence for that sort of proposition, or is it purely a leap of faith?

**Professor Rowthorn:** I do not know. If you look at any depressed region of the UK, you could ask whether, if they had been independent, they would have done a better job. It is hard not to think that they would have done, even if you cannot think why. With due respect to Scottish Peers here, one of the problems of being part of a larger country like the UK is that some of the most talented people go to the centre, whereas if you become an independent country you have a lot of opportunities for advancement where you are. It is possible that nationalist parties get a higher calibre of people than the local representatives of national parties. I am not saying that is true—it is a hypothesis.

Q234  **Lord Tugendhat:** Can I query that? You could take any small country against any large country. Canada is a big country but is only a 10th the size of the United States, as Scotland is about a 10th the size of the rest of the UK. Ireland, which has a very good
education system, has been educating very good people for the benefit of this country, Australia and the United States. There are jobs in Ireland but not a great many. Therefore, we, Australia and the United States benefit from this excellent school and university system and Ireland supports the rest of us. That is a rather odd situation.

**Professor Rowthorn:** Well, it goes in cycles. Ireland had a huge level of emigration and was then very successful economically on the basis of a huge investment in education. During the boom period a large number of people stayed in Ireland. Not only was it a net importer of labour but a lot of talented Irish people stayed.

**Q235 Lord Tugendhat:** That is true, but in the nature of things, however successful Ireland was being—it went through a period of very considerable success—there was only a limited number of jobs at a certain level in the Irish public service, medicine or business. That was the nature of the scale. It was doing very well on a small scale, but it was producing all these graduates who were coming here and going to the States, even when Ireland was doing very well. The suggestion that because a country is independent more people will stay is questionable. Look at the brain drain from Canada to the States and from Ireland to other English-speaking countries and that is the conclusion I draw. I do not think that independence makes a huge difference in that respect.

**Professor Rowthorn:** I think that there is a distinction between being independent over a long period of time and the initial burst of enthusiasm when you become independent. If you look at somewhere like Finland, when it became independent there was a period of a great mushrooming of nationalist fervour amid intellectuals and so on.

**Q236 Lord Tugendhat:** I know that a lot of southern Finns speak Swedish but Finland is not in the same language area as its neighbours, whereas for Canada and the United States and Ireland and the United Kingdom language is a very important point. Finnish is a bit of a one-off language.

**Professor Rowthorn:** The SNP is hoping that when Scotland becomes independent there will be a great upsurge of patriotic feeling, commitment and belief that there is a future there for people who would otherwise have left. Only the future will tell if that is so.

**Q237 Lord Hollick:** That rather begs the question of why Scotland is underperforming. It is interesting that in this *Global Entrepreneurship Monitor*, Scotland is in the bottom quartile—mind you, it is alongside Germany and one or two other countries, so I am not sure that that is a bad place to be. Iceland is at the top, but Scotland seems to be stuck at the bottom. It is a late performer by this particular measure.

**Professor Rowthorn:** The thing is that if you look at international comparisons of gross value added per hour, Scotland is very similar to Denmark, Germany and the UK. Oddly enough, they are all very close together. They are somewhat behind some other countries but they are very close behind Switzerland, for example. When you look at the figures, Scotland is not performing that badly. It has areas of massive unemployment in certain parts of Glasgow, for example, but its gross domestic product per capita excluding oil, which is the more meaningful measure, is very similar to the whole of the UK average. I do not think that, compared to the rest of the UK, it is underperforming. The point is that the per capita income in Britain up until 2008 was similar to that in Germany. It has only fallen behind during the recession. The British economy has not been doing that badly, contrary to what one might believe.
Lord Levene of Portsoken: Just on the point of defence procurement, under the Treaty of Rome each nation is allowed to do its own thing and is not bound to follow any particular rules on defence procurement, so there is no likelihood of what you suggested happening.

Professor Rowthorn: You mean we could basically say that we would not buy Scottish weapons.

Lord Levene of Portsoken: We could do whatever we like.

Professor Rowthorn: Okay.

Q238 Lord Smith of Clifton: Is membership of the European Union an essential part of the economic case for Scottish independence? Is membership of the EEA a worthwhile alternative option if the European Union option fails or is not pursued?

Professor Rowthorn: The only economic argument that I can see for joining the European Union rather the European Economic Area is that you may get less economic discrimination against you. In treaty terms, that is not supposed to be true because the European Economic Area is supposed to be a roughly equal thing. There are advantages to being not in the EU but in the European Economic Area. First, you would not have to pay subsidies to poorer parts of the European Union or to run the European Union administration or bureaucracy. You would have control over your own fishery policy so that you could, for example, protect your own fish stocks. From Scotland’s point of view, there are advantages to not being in the European Union. Of course, if everyone applied that argument, the European Union would fall to pieces. It may be that the collective benefits of the institution, such as they are, would disappear. Nevertheless, from a purely egotistical point of view, it might be to Scotland’s advantage not to join the EU but to join the European Economic Area.

Lord Smith of Clifton: Presumably, in one sense it supports the case of Scottish nationalism and independence if Scotland was not part of the Union, or they would just be coming out of one union and going into another.

Professor Rowthorn: Out of the frying pan into the fire.

Q239 Lord Smith of Clifton: Exactly. Do you think, comparatively, looking at Catalonia’s preference for devo-max within Spain, that there are lessons for Scotland?

Professor Rowthorn: I know nothing about Catalonia’s devo-max. I have been on holiday to Catalonia and I know a few economic things about it, but I am afraid that its devolution arrangements have passed me by.

Q240 Lord McFall of Alcluith: You said earlier on that it is best to know what you are buying and what you are paying for but that that will not happen because of the politics of it. When Professor John Kay was here a couple of weeks ago, he spoke about a lengthy period of negotiation if there was a “yes” in the referendum. In fact, he said that it would take years of negotiation following a “yes”, with uncertainty. Do you agree with that? If so, what are the implications of that?

Professor Rowthorn: I do not know how long it would take. Czechoslovakia broke up in very short order and quickly. I am not convinced that it would take years and years. It would be a matter of will. Some people might want to spin it out but I cannot see why it would take that long, especially since Scotland is relatively autonomous now. It is not fully autonomous but it has an extensive Administration of its own. It would not need to set up a new legal or education system, et cetera.
Lord McFall of Alcluith: I think that Czechoslovakia had 30 treaties and 12,000 legal agreements.

Professor Rowthorn: But it still separated pretty fast.

Q241 The Chairman: Given what we have been discussing, not least in relation to North Sea oil, the Barnett formula and the rest, do you not think that it would be a long and protracted negotiation?

Professor Rowthorn: I think it might be quite a thorny negotiation, yes. I have no idea how long it would take. Where there is a will, there is a way.

Q242 Lord Lawson of Blaby: I have a quick question on the EEA. I absolutely follow your logic in saying that membership of the EEA might be a much better bet for an independent Scotland than membership of the EU. However, am I not right that Scotland cannot unilaterally become a member of the European Economic Area? There has to be an agreement with the European Union, which may or may not be forthcoming.

Professor Rowthorn: That is right, but who knows? It might be that Spain blocked Scotland’s membership of the European Union because of it being an example to Catalonia. It might be that the UK blocked it. On the other hand, these countries might not block its membership of the EEA. I agree that it is a club and it is not open to anyone to join without permission.

Q243 The Chairman: Professor, we have covered a very wide range of topics. Are there any other points that you think we have missed that you would like to put before us?

Professor Rowthorn: No, I have had to answer questions on a whole of range of things. I expected some because I had recently received a list of the possible areas of discussion but some of them I had not thought about at great length before.

The Chairman: Thank you very much indeed for a very helpful session. Again, I thank you for a really excellent paper. Many thanks for coming.
TUESDAY 13 NOVEMBER 2012

Members present
Lord Tugendhat (The Chairman)
Lord Hollick
Lord Levene of Portsoken
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Skidelsky
Lord Smith of Clifton

Examination of Witnesses

Sir Philip Hampton, Chairman of the Royal Bank of Scotland, and Stephen Boyle, of the Royal Bank of Scotland, gave evidence.

The Chairman: Sir Philip, welcome to the Economic Affairs Committee. This is the 15th public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. Copies are available in the Room of Members’ entries in the register of interests which they have been declared as relevant to the inquiry. I do not think it is in any way relevant to the inquiry, but I certainly am a client of one of your subsidiary companies in the ordinary banking relationship way. Please speak loud and clear for the webcast and the shorthand writer, and because I am hard of hearing. Would you like to begin by making an opening statement, or would you like us to go straight into questions?

Sir Philip Hampton: Thank you very much, Lord Tugendhat. I would like to make an opening statement if I may; I will read from a script. I thank you and Members of the Committee for this opportunity to give evidence. We have 14,000 members of staff in Scotland, and RBS is one of the biggest employers north of the border. We have been in business in Scotland since 1727, which makes us one of the oldest businesses in the world in continuous operation. We are very proud of our Scottish roots. We have strong connections to businesses and communities throughout Scotland and are well served by a
population that have the skills and education that the bank is looking for. We have always been able to retain and recruit quality staff.

We are monitoring the independence debate but, as I and my colleagues have said many times, we are politically completely neutral. We do not support any political parties or movements. We will respond to whatever voters decide and the Governments agree. Our first job, of course, is to serve our customers and, through that, to reward our shareholders. We are looking forward to getting clarity in the coming months from both the Scottish and the Westminster Governments on the implications of a vote for independence for customers, shareholders and other stakeholders. Clearly, there are issues that we are looking at, all of which, I understand, have been discussed in the Committee before: currency, the application of financial regulation, lender of last resort arrangements and so on. There may also, and probably will, be policy issues which are determined in the aftermath of a yes vote, if that is what happens in the referendum on independence. Obviously, we cannot predict those outcomes. All I can say is that RBS as an organisation will be prepared to the best of our ability for whatever the outcome is.

The chair of our Scotland board is fully engaged with a number of organisations, such as Scottish Financial Enterprise, which are looking at issues for the financial and business sector. Members of the Scotland board and the group board have met leading politicians, including First Minister Alex Salmond and the Scottish Secretary Michael Moore. I note that both the Scottish Government and the UK Government are to produce a number of different policy papers which, of course, we will study very closely.

We are monitoring this against the backdrop of rapid and complex change in the banking sector, particularly for large, systemically important banks, of which RBS is officially one. We have the banking reform Bill, more recently the Liikanen report from Europe, changes globally—particularly in Europe and the United States—and numerous other things going on that are shaping the environment that we work in. This of course all adds to the complexity around the independence debate. However, as I say, we will continue to monitor the debate and engage. Clear plans from us, of course, will require much greater clarity on where the proposals eventually settle.

Q757 The Chairman: Thank you very much. I will ask the first question, and then we will go around. In the event of Scotland becoming an independent nation, there is a widespread expectation that the Scottish Government would opt for the use of sterling as the currency. What do you consider should be the key economic issues weighed up by the Scottish Government when making this decision? Do you think it is feasible for the Scottish Government to use sterling without the agreement of the Government of the rest of the United Kingdom?

Sir Philip Hampton: There are probably two parts to that. Of course, there are countries that use currencies that they do not themselves control. I lived in Liberia, in West Africa, for the best part of a year 30 years ago, where they used the US dollar quite freely as the currency of exchange. It was accepted by everybody in the country. I think that the same is true of Panama, which uses the US dollar. Montenegro uses the euro. None of those countries control those particular currencies. That is possible for Scotland, but I think that Scotland is probably too big and advanced an economy for that sort of arrangement—probably. If there is a proper sterling union, it is a significant question as to what underpins that currency union. Every Member of the Committee, of course, will be acutely aware of the implications of currency union and the stresses and strains it is producing in the eurozone, where you have currency union without fiscal union. Plenty of people have said
that in order to keep it together you need fiscal union and then, in due course, political union. Potentially, you sort of come back on yourself.

The short answer to your question is that we do not know. We can see the issues and challenges that are there for Scotland to continue to use sterling without necessarily exercising control over that union, but we would have to see. It would be part of the independence debate and part of the changes that would eventually have to be agreed if there was a currency union in that sort of organised way between the respective Governments. We can see the challenges of it. What sort of solutions might be around that, we do not know.

The Chairman: In the past, the Scottish National Party was in favour of the euro. Do you think that, in present circumstances, there is—or is likely to be—a case for Scotland adopting the euro rather than sterling?

Sir Philip Hampton: In the end, in the event that there is an independent Scottish Government, which is the most suitable currency to follow is a matter for them to work out. They will make their judgments at the time depending on the circumstances at the time. I think it would be a braver step to go into the euro, given the historic trading links and the ease of currency movement we have had around the United Kingdom for a long period of time, but it is not impossible. We see the example in the island of Ireland: you have sterling in the north and the euro in the south, so you can make it work.

Lord Levene of Portsoken: Sir Philip, coming back to sterling, if an independent Scotland chose to use sterling as its currency, do you envisage any arrangement whereby the Bank of England could still provide traditional central banking services such as lender of last resort to Scottish-based financial institutions?

Sir Philip Hampton: It is an important issue for us. As I suggested in my opening statement, lender of last resort facilities are essential for a bank to have available. I do not know, sitting here at the moment, what arrangements might be put in place in the event of an independent Scotland within some sort of currency union. That would be a matter that would have to be agreed between the two Governments and the Bank of England. From the point of view of RBS, it would be important to know that we had appropriate lender of last resort facilities for our operations.

Q758 Lord Levene of Portsoken: I am sure you must have looked, but do you have any views that you would like to express as to what sort of effect it would have on RBS were an independent Scotland to choose to continue with the pound sterling as its currency as opposed to, say, the euro?

Sir Philip Hampton: It would depend. They could use the Zambian kwacha if they really wanted to. Any currency that is accepted as a means of exchange is a de facto currency that could be used. If there is a vote for independence and the Scottish Government decide that they are going to have sterling as the currency, as I said, they would need to agree the institutional arrangements for that currency union with both the UK Government and the Bank of England. As I say, that gets you into the discussion about the fiscal harmony, and so on, that is eventually necessary to support a currency union.

Lord Levene of Portsoken: As the Bank of England is explicitly indemnified for losses by UK taxpayers, it would be difficult to work out how the taxpayers in one country could guarantee those of another.
Sir Philip Hampton: I take the point entirely, Lord Levene. What the answer is I do not know, but it is obviously an important matter for the Court of Directors of the Bank of England, the Treasury and the UK Government.

Q759 Lord Hollick: It would seem that, absent a lender of last resort, RBS, based in Scotland, would be at a severe competitive disadvantage in the marketplace.

Sir Philip Hampton: It would depend on the arrangements. We should not think that lender of last resort facilities relate only to the top company in any bank. For instance, at the time of the financial crisis in late 2008, because we have substantial operations in the United States, we used the US Federal Reserve as a lender of last resort, providing short-term liquidity when the market completely dried up. The Fed gave us lender of last resort facilities amounting to many tens of billions of dollars. That was because we had a US banking licence and we were operating in the United States. A central bank does not want its banking system to collapse, so it acts for all the banks that are operating in that country.

We have used many central banks as a lender of last resort for the many operations that we have in the many jurisdictions in which we operate. That is a key part of what central banks do in the jurisdictions that they control. Just because there might be an independent Scottish Government does not mean that all our lender of last resort facilities would disappear; they would be continued.

Lord Hollick: You would still continue to benefit from the Bank of England being the lender of last resort for your operations in London, but that would leave Scotland, which is where the holding company is, rather out on a limb.

Sir Philip Hampton: It is important, as I said at the start, for all our operations to have clear, understandable lender of last resort support in the event of another financial crisis—heaven help us, but that is a risk that banks and central banks need to be ready for. If independence and the structural changes associated with that produce a problem, there would have to be a solution.

Q760 The Chairman: Presumably, as you are 80% owned by the UK Government, were that to be the case at the point of separation, one would expect your ownership to be divided in some way between the United Kingdom Government and the Scottish Government.

Sir Philip Hampton: Possibly. I have heard that suggestion but I have not heard it officially—unless this is official.

The Chairman: No, I was seeking information.

Sir Philip Hampton: Clearly at some stage or other there is a “share of the cake” discussion to be had—a share of the cake and a share of the debt—but we have not been approached on that debate yet.

Q761 Lord Rowe-Beddoe: Sir Philip, can we move to the topic of regulation? In the event of an independent Scotland, do you envisage that financial regulation could still be conducted by the PRA as a single pan-UK body?

Sir Philip Hampton: It would be unusual for a regulator in one country to regulate the activities of a bank in another country. It is possibly unprecedented, at least in modern, advanced economies. I have had no indication of what the arrangements would be. Obviously, from our point of view, we would want regulation to be as simple and straightforward as we can have it. We are already dealing with a dazzling array of regulators
in different parts of the world, so extra levels and layers of regulation would not be our first choice. Having said that, one regulator dealing with another country’s regulatory affairs is also quite complicated. How this would be worked out I do not know.

**Lord Rowe-Beddoe:** If the PRA, for example, were to regulate Scottish institutions, it would imply, I suppose, that it would have responsibility and therefore liability.

**Sir Philip Hampton:** I think that there is a difference between responsibility and liability, at least technically or legally. Whether an independent Scottish Government would want to set up their own regulatory infrastructure or effectively make use of an alternative regulatory structure, and whether those other regulators would be ready to supply their services, I do not know; it is premature to guess at that.

**Q762 Lord Rowe-Beddoe:** What if you were able to have a wish? Would you prefer an independent regulator or a pan-UK regulator?

**Sir Philip Hampton:** I am not sure I have a strong preference. The overriding preference would be for simplicity, because we already have enormous complexity.

**Q763 Lord Levene of Portsoken:** Just a supplementary on that. You said, “If the PRA were to regulate Scottish institutions”. Presumably you have given some thought to whether you would be a Scottish institution. The company is formally registered in Edinburgh. If Scotland became independent, would you have to look at where the bank was domiciled?

**Sir Philip Hampton:** The overriding requirement, as I said right at the outset, is to serve our customers and through that to produce the best value that we can for shareholders. We have no intention or plan to relocate from Scotland. We have been asked many times in the wake of the financial crisis whether we should change our name from the Royal Bank of Scotland and whether it is in some way or other damaged by the crisis that the bank went through. Every time we have looked at that we have said, “No. We will remain the Royal Bank of Scotland and we will remain domiciled in Scotland”. We are very happy that it is a very effective place for us to do business at the moment.

If, as a result of a vote for independence, we found extra difficulties, cost pressures or whatever, we would have to think about alternatives, but we do not identify any clear rationale for making major domicile changes.

**Q764 Lord McFall of Alcluith:** Businesspeople have been largely absent from the debate on independence for understandable reasons—except for you, so it is nice to have you along. I was at a dinner last Friday evening with a prominent businessperson who was talking about the uncertainty created presently and in future, if there was an independence vote and negotiations were going on between the Scottish Government in the UK Government. One instance was given to me of one of the research foundations giving grants to universities. They do that on the basis of a five-year planning horizon. That was causing some concern, even at this time. Have any customers raised concerns about the future? If not, is that a possible issue for the future?

**Sir Philip Hampton:** I have not had that feedback from customers yet, either south or north of the border. I do not think that it has yet come into it. A lot of people expect that the vote will be a no vote—that is what the polls say, anyway—so people do not regard it as a likely issue. I am speculating, but there is probably a general expectation that the difficulties that might arise will be dealt with. Whether that is a reasonable expectation or not it is too soon to know. This is not front-of-mind yet from a customer point of view, not that I have heard.
Lord McFall of Alcluith: As a businessperson, you have operated on reasonably long planning horizons. Do you see that concept as important to business and one that business will reflect on as the time gets nearer?

Sir Philip Hampton: I am not sure that there are profound customer implications in terms of longevity of doing business. If there is an issue on a long-term horizon, it would be funding arrangements where we take money on a longer term basis. As I have said publicly a few times, domicile can be important to providers of funds. I think that was the question that Lord Hollick was underlining. Again, there is no sign of that happening yet in terms of market activities from our point of view.

Lord McFall of Alcluith: I am mindful of the situation in the US, where the changes to the functions of Fannie Mae and Freddie Mac to hold an inventory of sub-prime debt arguably changed the effectiveness of financial regulation. If there is a single financial regulator for an independent Scotland and the rest of the UK, how do you envisage the Government being kept in check so as not to pass legislation that would effectively undermine the regulations and therefore increase the risk for one country or the other?

Sir Philip Hampton: Do you mean in terms of regulatory arbitrage between Scotland and the rest of the UK?

Lord McFall of Alcluith: Yes.

Sir Philip Hampton: I do not know. In the event that we have completely independent Governments, I guess that the question of regulatory arbitrage would arise.

Lord McFall of Alcluith: Good, I thought that was your answer.

Sir Philip Hampton: Clearly it might; it does at the moment. It is all subject to single market issues around Europe. There are limits within the European Community to regulatory arbitrage.

Lord Skidelsky: Although most attention is given to the regulation of banks, in the light of events, how might the regulation of non-bank financial firms be affected by an independent Scotland? For example, in your view is it necessary that insurance companies and banks have the same regulatory body? Would it be necessary for Scottish insurance firms to be regulated by the same body as their counterparts in the rest of the UK? How do you see that situation involving in the light of independence?

Sir Philip Hampton: All these models are evolving in the UK and elsewhere. Our preference would be, because there is so much complexity and so much change in regulatory structures and regulatory drivers affecting banks and insurance companies—we own a large insurance company called Direct Line—for things just to be as uncomplicated and unchanging as they can be. We have an awful lot of fish to fry still in RBS’s recovery so, as a general rule, the more recognisable and the simpler the changes, the better from our point of view.

Lord Skidelsky: In other words, independence would be bad for simplicity.

Sir Philip Hampton: Independence adds an extra potential layer of complexity to some of the issues that we address as a bank. As I said in my opening remarks, we already have the Vickers report, which we have to implement, and the Liikanen report, which we may have to implement if the European Commission drives through its proposals. We have quite complex changes still under way in the United States, where we have a substantial retail and commercial business and wholesale banking activities. We have a lot of structural change.
that we are addressing as a bank, which has implications for all the things we are discussing—whether it is lender of last resort facilities, which operations we have, which lines of business sit in which corporate entities within the group, and so on—so, self-evidently, we are not looking for significant further complexity and change.

Q768 Lord Skidelsky: Once you set up a new border, a lot of consequences follow which make life more difficult, I imagine.

Sir Philip Hampton: Yes, but if that is what voters decide and Governments agree, then we will get on with it.

Q769 The Chairman: I understand the points that you are making about simplicity, clarity and so forth, but if the voters decide on separation, you will then be confronted with a prolonged period of uncertainty while new arrangements are being worked out. You have been subjected to questioning here about what the new arrangements might be, but there will be a period—I do not know how long—when you will not be clear what the arrangements will be, whereas your opposite numbers based in London will be clear because there will be no change for them.

Sir Philip Hampton: True, and there may be no change for us.

The Chairman: There may not be, but there may be.

Sir Philip Hampton: I agree. Certainly, an extra level of uncertainty potentially arises as a result of domicile. That is plain.

Q770 Lord Shipley: You referred earlier, more than once, to the complexity of the independence debate. In the context of whether Scotland should continue with sterling, you said that that would be part of the independence debate. I am not clear whether you think that that debate should be before or after the referendum. Should those voting know what the likely outcome of the vote might be?

Sir Philip Hampton: It is not for me to put proposals to the voters in Scotland. As a general principle, I think it is a pretty good idea, if people are voting for something, that they know the pros and cons of what they are voting for. I should have thought that for most voters, knowing the currency implications of an independent Scotland would be a helpful—indeed, fundamental—piece of information.

Q771 Lord Shipley: Do you think that an independent Scotland, with a smaller tax base and probably a smaller borrowing capacity, would have an effective limit on the size of financial institutions that could be headquartered in Scotland, or would there be a perception that any too-big-to-fail institution would soon become an issue for the rest of the UK, so that the growth of Scottish-based banks would not in practice be constrained by independence?

Sir Philip Hampton: Yes, most of the discussion that we have had so far has been about lender of last resort, which eventually comes down to liquidity, which has been a big issue for banks in recent times. We have become massively more liquid as a bank. We had very little liquidity as we went into the financial crisis. We now have a liquidity portfolio that is £145 billion. We have been transformed in liquidity terms, and in our need for wholesale funding. Our short-term wholesale funding needs are now relatively trivial. Of course, they almost overwhelmed the bank five years ago.
Your question about too big to fail comes into equity rather than liquidity and funding. I said publicly that you tend not to get large banks in small countries, partly because of liquidity, partly because of “too big to fail”—the long-term backstop to equity. Our drive at RBS in the past three or four years—and indeed the whole drive of international regulation, particularly in the UK, because of the scale of our financial crisis—has been to break that link between the sovereign and the bank. It is still a powerful link, particularly in southern Europe and I would not pretend that it is entirely gone from the United Kingdom, but the whole direction of our strategy is to say: this bank must stand on its own feet, regardless of sovereign backing, because we do not want to have access to UK taxpayers any more to sustain our operations. I am sure that UK taxpayers, the UK Government, the Bank of England, the FSA—and, I assume, most Members of the Committee—do not want taxpayers to have to bail out banks in the future. The whole drive of what we are trying to do is to break that link and make sure that we run the business so that it does not need access to any sovereign support from whichever country.

**Q772 Lord Shipley:** Do you think that an independent Scotland, which could be substantially indebted after inheriting a proportion of UK government debt, will be in a position to provide financial system insurance or might the size of institutions headquartered in Scotland be limited? Do you think that as a consequence there might be some migration of firms across the border, in either direction?

**Sir Philip Hampton:** The key driver is to make sure that you do not need the sovereign backing. That is what we are trying to do. Scotland is a long established country and a perfectly reasonable place for us to have been domiciled throughout our entire history. We do not see any necessary reason why, in conjunction with our strategy, that should not continue to be the case, but we also need to get to the position where the sovereign link—the potential perception of markets that sovereign backing is important—is decisively broken.

**Q773 Lord Lipsey:** One of the points of separation is that countries can have different policies. One can imagine certain kinds of policy that could be different either side of the border. For example, in the employment field, one Government could go for the so-called living wage while the other sticks to the minimum wage; or one could have very strict unfair dismissal laws but the other could largely have got rid of them. Do you think that those differences could be fundamental enough to threaten what is effectively the single market between Scotland and England if Scotland did go for independence?

**Sir Philip Hampton:** Of course, devolution of some economic powers to Scotland and indeed the Welsh Assembly has produced differences, obviously, in what happens north and south of the border. The whole idea of devolution is to give more local powers. That is what has already happened and is in the process of being reinforced anyway. There clearly will be differences, which at some stage or another will impact on people’s lives and business drivers. That is part of local devolution. I am assuming—I may be wrong—that over time these things will not be utterly decisive, because the overarching framework, assuming that Scotland and the UK stay within the European Union, is that we have a single market for the main products and services, including financial services. The overriding existence of the European single market and the presence of a potentially independent Scotland and the United Kingdom within that should trump relatively smaller, effectively regional differences that might arise.
Lord Lipsey: There is also a problem of complexity for an organisation such as yours, with many people working in both countries having to take on an extra set of differences between two major countries in which you are operating.

Sir Philip Hampton: That is the trade-off. There is an argument that a focus on regional autonomy will produce extra growth or wider decision-making or whatever, versus extra complexity.

Q774 Lord Hollick: Sticking with the single market, as you know, the direction of travel in Europe is towards a single financial regulator, from both a prudential point of view and a lender of last resort point of view. Given the significant reservations that the London financial centre has about that structure, is that not likely to push an independent Scotland towards adopting the euro and becoming part of that? Looking at it from the point of view of RBS, an international bank, would that not be a more comfortable place to be?

Sir Philip Hampton: As a bank we deal with loads of currencies all over the world. It is part of what we do. It happens to be part of how we make some of our money. Subject to it being a formal currency union in sterling, which will need institutional arrangements from the Bank of England and the UK Government, if the Scottish Government decide they want to use the euro, we will adjust our business model to take account of that.

Q775 Lord Hollick: On a point of information, what proportion of the bank is in Scotland and what proportion is in the rest of the United Kingdom, particularly in London, by size of balance sheet?

Stephen Boyle: We do not know the size of the balance sheet. We can come back to you on that. We have just short of 100,000 people in the UK, of whom about 14,000 are in Scotland.

Lord Hollick: So if money follows people, you are substantially in London and the rest of the United Kingdom.

Q776 Sir Philip Hampton: National Westminster Bank plc still exists. It is a wholly owned subsidiary of RBS. The National Westminster Bank has a far larger number of customers than RBS does. I think I am right in saying that the number of customers who use RBS as a name, as opposed to Coutts, the National Westminster Bank or the Citizens Bank in the United States, is something like 3% or 4%. So massively the greater part of business is not in Scotland. Lord Hollick: You mentioned the word “domiciled” a couple of times, which brings to the fore the question of where the substantive base of your activities would be. From an operational and strategic point of view, I guess you would have to make some judgment in the light of the settlement that came out of this as to where you really wanted to plant your flag for the major part of your business.

Sir Philip Hampton: As I say, we have no intention of changing domicile. In the list of priorities that we are working through as a bank, changing domicile would not figure prominently. We have lots of other things to do.

Q777 Lord Hollick: But it would follow that you would have to look objectively at the situation that followed a vote for independence and, having regard to the fact that the greater part of your business was in what would then be a smaller United Kingdom, you would have to adjust your strategy in the light of that.

Sir Philip Hampton: Self-evidently, if anything happened—a vote for Scottish independence or anything else—that was prejudicial to our customers or shareholders, we would have to
think of an appropriate response to it. That may come through the institutional arrangements that are made between the Governments following a vote for independence. If we were not satisfied by those arrangements, we would have to think of an alternative under our own steam.

Q778 The Chairman: We keep coming back to the question of uncertainty; that is the nature of the beast. Of course, you are in a position of great uncertainty because you do not know which way the vote will go, obviously, or what an independent Scottish Government would wish to do on a number of areas. But if you are in a state of perplexity, so too are the customers of your bank outside Scotland. We are approaching the period when a Scotland-based financial institution ought at least to inform its customers outside Scotland that there is now an additional element of uncertainty in the relationship that does not apply to financial institutions that are based south of the border. I think that the requirement is strongest in the case of long-term contracts such as annuities, life assurance and mortgages. But would you not agree that your customers in the rest of the United Kingdom ought to be informed of the uncertainties about which we are talking today?

Sir Philip Hampton: There comes a point in any communication with customers, shareholders and stakeholders generally where risk factors need to be identified. I am sure we are not at that stage yet because there is just too much uncertainty. There is almost nothing to communicate because there are no proposals for anybody to consider and for any issues arising from that to be properly calibrated. Going back to the issue of where our customers sit, overwhelmingly they sit in legal entities that are separately capitalised and licensed, which are not RBS; for example, Coutts and National Westminster Bank. They are banks with their own licences and capital structures. They happen to be owned by RBS, through the ownership chain that we have, largely as a result of the takeover of NatWest in 2000, but they are banks, with their own customers, balance sheets and licences.

The Chairman: None the less, in the light of all that has happened, when people see that a bank is based in a different sovereign area—Ireland, Iceland or India or any of the other countries from which banks offer services in the United Kingdom—people who would not have thought twice about the nationality of a bank before might think twice now about whether they are dealing with a bank that is based in the same country as they are, or a bank that is based in another country or in a place that might become another country.

Sir Philip Hampton: You may be right. As I say, there is no sign of that from our customer base and it is not clear to me that there is any need for customer anxiety at the moment on the basis of the information that we have.

Q779 Lord Levene of Portsoken: As a follow-up to that question—I was thinking along the same lines as Lord Tugendhat—as we have heard, the vast majority of your customers are with subsidiary banks that are not based in Scotland. At present, one would imagine that those customers, to the extent that they know that, are not terribly fussed about it because they are all based in the UK. However, it would be a fundamental change if NatWest, which is presumably the largest in terms of customers, was no longer owned by a UK bank but by a bank in a foreign country. I understand that we are a long way away from that at the moment and it may not happen anyway. But if it did, it would be a huge issue as to how you would communicate that to your customers and what you would say to them, so I imagine you must be giving some thought to that.

Sir Philip Hampton: We have a board meeting of the National Westminster Bank every time we have a board meeting. The board of the National Westminster Bank is the same as
the board of RBS. Some of it goes through quite quickly because we have already dealt with
the issues on a group basis but nevertheless, the National Westminster Bank is separately
licensed, separately capitalised and regulated by the FSA according to all the FSA’s
requirements. The topco issue is not significant for the safety and soundness of the capital
structure of that bank and the security of customers.

Lord Levene of Portsoken: Absolutely, that must be the case. If in due course NatWest’s
topco was domiciled in a different country, presumably there would a very important issue
for your customers as well to consider.

Q780  Lord Smith of Clifton: At one time the Northern Bank in Northern Ireland was a
subsidiary of an Australian bank. We can probably find out whether there was any customer
drain as a result of that. Having lived there, I did not see any perceptible difference among
the customers of the Northern Bank as to whether or not it was owned outside the
jurisdiction.

Sir Philip Hampton: I am not saying that this is a non-issue; it is just a question of how you
scale it and whether there are any valid causes for concern. Banks all over the world are
owned by international banks. We have many subsidiaries in many countries. People may
take a different view on the UK or whatever. The same is true for many banks in many
different parts of the world. One thing that is happening in the banking industry is that it is
almost deglobalising; because of the financial crisis there is much more local control and
much more concentration on whether a bank in a particular jurisdiction is appropriately
capitalised for that jurisdiction. I have conversations with regulators in different parts of the
world and they say, “We don’t give two hoots about what is going on in the UK. We want
to know that RBS’s activities in this jurisdiction are appropriately capitalised, appropriately
funded, and able to deal with customers in this jurisdiction. The rest of your international
activities are not important to us”. You get that in the United States, Singapore—all these
jurisdictions. Big international banking groups are focusing much more on local capability,
local funding and local capital adequacy, which has been driven largely by fears that
regulators in one part of the world cannot necessarily rely on regulation in another part of
the world. Of course, the UK has been an important part of that.

Q781  Lord McFall of Alcluith: Sir Phillip, you mentioned that 14,000 people are
employed in Scotland out of 100,000. Given the glass palace that is Gogarburn, do you
envisage the wind whistling through its empty corridors in years to come?

Sir Philip Hampton: I have not heard it called a glass palace before, but it is certainly an
excellent facility. No, Gogarburn is a very good facility. I am not sure that we would build it
quite to that standard now; it is of a remarkably high standard and was built at the peak of
the profitability of the bank. I think that we would be much more careful now, but it is an
excellent facility with an excellent workforce who do a thoroughly professional job. It is not
clear that we could find a cheaper or better place to have that facility than in Gogarburn.

Q782  Lord McFall of Alcluith: Lastly, you mentioned apportioning the assets of the
Royal Bank of Scotland between the UK and an independent Scotland. Will you save us the
bother by 2014 or 2015 by having it fully integrated into the private sector so that that
question is redundant?

Sir Philip Hampton: I wish that that could be the case. It is certainly our profound wish to
get the Government off the share register as soon as possible. Our hope—I have said
publicly that I think it is a reasonable aspiration, but it is not straightforward to do—is that
we will have finished the restructuring of RBS in the next couple of years or thereabouts and
will be able to present a bank that is properly restructured and can be presented to new investors in order for the Government to begin the process of selling down their shares. Whether they find the price of shares attractive at that stage will be a matter for the Government, but we hope to finish the clean-up, if you like, in the next couple of years.

Q783 Lord Smith of Clifton: Sir Philip, you alluded earlier to the island of Ireland and the two currency regimes operating. My question relates to that. Do you think that an independent Scotland would seek to introduce different corporation tax rates from the rest of the UK? Would independence mean that tax relief could not be claimed on one side of the border for losses made on the other? Would this be an important issue for financial firms which have a headquarters north of the border but carry out much of their business south of the border?

Sir Philip Hampton: These are obviously important issues. As to whether there are different taxation arrangements north and south, these are issues that will have to be thrashed out in whatever separation arrangements are made—as I said, the sharing of the cake and the sharing of the debt. I assume that agreements on things such as taxation will not be that enduring. The whole idea of independence is that you have some flexibility to change those things. They will be matters, in the end, for a Government, not for us.

Lord Smith of Clifton: As you know, it exercises business in Northern Ireland to a considerable extent, bearing in mind the competitiveness with the south, the Republic.

Sir Philip Hampton: Some of the issues arising from this can be very profound. When I was chairman of Sainsbury’s, I remember that its busiest store for a long period was in Newry. It was about the 300th largest store but it was the busiest because people from the Republic were queueing for hours and hours when sterling declined. It was significantly cheaper for people to drive halfway across Ireland to get into Newry. Contiguous borders with different cost structures and different currencies will produce opportunities and costs.

Q784 Lord Levene of Portsoken: Do you think that Scottish voters in general and business leaders in particular have enough information about the economic implications of independence to make an informed choice in the referendum? What further information, if any, would be particularly helpful for your institution, the RBS, prior to the referendum?

Sir Philip Hampton: Nobody has enough information. In a sense, that is reflected in the discussion that we are having. There are lots of issues that need to be clarified, but it will be a matter primarily for the Scottish Government to decide what information is eventually put to voters. One should work on the assumption that enough information will be put to voters. It would be premature to say now in relation to RBS what specific information is needed or would be appropriate to put to voters. As I said right at the start, we are engaging with the Scottish Government on these issues. They know the issues that we have and the issues that the Committee has been addressing about currency, regulation, lender of last resort arrangements, and so on. I work on the assumption that in a democracy voters will be given all the necessary information.

Q785 Lord Levene of Portsoken: As a very large business in Scotland, the actions and work of the Scottish Government are clearly very important to you. The decision on whether Scotland should become independent or not will also be very important to you. The Scottish Government have clearly expressed their view that they believe that independence would be a good thing for Scotland. There are always two sides to every story. Does it seem to you, as a large business based in Scotland, that both sides of that
argument are putting their case fully across and will it have got fully across, in your opinion, by the time it comes to the referendum?

**Sir Philip Hampton:** I do not know what information would be given. I just express the hope and expectation that comprehensive information will be given. Clearly, the various parties to this political debate have an objective. That is bound to be reflected in the arguments that they make but hopefully not in terms of the information that is available.

**Q786 Lord Hollick:** Can you tell us how Scottish business is approaching this problem of uncertainty? Do you meet together? Is there a forum where Scottish companies, large and small, meet together to share their concerns and anxieties? Or is the situation at the moment one where the yes vote can only command one quarter, so this does not look to be a real world problem?

**Sir Philip Hampton:** Can I ask Stephen Boyle to answer that, because he sees them more than I do?

**Stephen Boyle:** Thank you, Sir Philip. Certainly, for ourselves and similar companies, we work closely with and through Scottish Financial Enterprise. I know that you have heard from Owen Kelly of Scottish Financial Enterprise. The endeavour there is to obtain as much information as possible from both Governments about their views and plans as to what the future might hold under different outcomes.

**Q787 Lord Hollick:** Have you received assurances from both London and Scotland that the respective Governments will be in a position to answer your questions in good time for you to weigh up all the issues?

**Stephen Boyle:** We know that the Scottish Government intend to publish a White Paper in about a year’s time, that they have appointed a fiscal commission to deliberate on issues concerning fiscal policy, and that the UK Treasury is also actively engaged in preparing a number of papers on a range of issues. We are hopeful that from both the Governments’ endeavours we will secure the kind of information that we require.

**Q788 The Chairman:** Sir Philip, the Royal Bank of Scotland, in all its various manifestations, has its finger on the pulse on local economies throughout the United Kingdom. It is one of the things that banks such as yours really know about. We sometimes hear from people in Scotland—you mentioned this yourself earlier—that one reason for independence is that it would lead to local decision-making in relation to economic growth and that this will release energies that have hitherto been restrained. Of itself, therefore, independence will lead to an upsurge in economic activity. I suppose, mutatis mutandis, the same probably could be said of England. When you look at England, Wales, Scotland and Northern Ireland, do you feel that a separation of Scotland from the rest will lead to an upsurge in economic activity in England or in Scotland? If so, why, and if not, why not?

**Sir Philip Hampton:** Stephen, perhaps you could start and I will see if I can add to it.

**Stephen Boyle:** I have a strongly vested interest in this because I live in Scotland. Thinking about this over the long term and about what makes economies grow quickly or slowly, in the long run it is the ability to promote rapid productivity growth that does or does not give us strong economic growth. I find it difficult to understand why changes in constitutional arrangements, from the ones we have at present to, for example, independence for Scotland, would necessarily lead to faster or slower growth in the long run. If we have either the status quo or Scotland operating as a western democracy respecting property rights and the
rule of law, I cannot understand why those two alternatives would yield significantly different economic outcomes in the long run.

Sir Philip Hampton: So there you are: we are economically neutral as well as politically neutral.

Q789 Lord Rowe-Beddoe: Sir Philip, a moment ago you said that your belief in democracy was such that the parties to be asked to exercise their vote were properly informed. I am not putting words into your mouth but I think that is the meaning of what you said. I am sure that we all heartily agree with you. This is obviously one of the main reasons of this inquiry: to inform the people who are about to vote. I hope only that our democratic system will do a better job than so far demonstrated in the forthcoming election of police commissioners on Thursday.

Q790 Lord McFall of Alcluith: Perhaps we could have another look at that. In terms of the economy, I understand where you are coming from, but different structural issues exist between Scotland and England. Given that Scotland has a higher proportion in the public sector, are there particular issues for Scotland as opposed to England?

Stephen Boyle: I sometimes say to other colleagues that the part of the UK economy that most looks like the UK economy is Scotland. There can be a tendency sometimes to exaggerate what are minor differences. You are correct that the proportion of the Scottish economy accounted for by the public sector is greater than in the rest of the UK. As measured by employment, 22% to 23% of Scotland’s workforce is in the public sector and in the UK as a whole it is 20% to 21%. I do not think that the structural differences are substantial.

Q791 Lord McFall of Alcluith: In essence, your answer is productivity. Are you optimistic about Scotland gaining in that productivity with a higher proportion of public sector jobs than in some other areas of the country?

Stephen Boyle: Certainly, if the public sector is very large—perhaps not North Korean large, but very much larger than in Scotland and the UK—it is quite possible that the size of the public sector could constrain growth if it crowds out private sector activity. I do not think that either Scotland or the UK is at that point yet. Therefore, the important thing is to make sure that the public sector plays its role in maximising the productivity of the economy.

Q792 Lord Hollick: You have admirably maintained a position of neutrality. Perhaps I could invite you to consider the consequences of the impending structural changes that are coming about as a result of the Vickers report. Whether it is a ring-fence, a concrete wall or total separation, if that were to apply only south of the border how would you think about that in terms of your location and where you would like to base your capital markets business?

Sir Philip Hampton: Gosh, that is a big question. We have not decided yet—because the legislation is not clear enough yet—exactly where we would draw our ring-fence within our current corporate framework; whether we have a big ring-fence or small ring-fence or something in the middle, we have not finally decided. At the moment the activities of the bank north of the border would nearly all comprise a Vickers-compliant business, because a relatively simple set of retail and commercial activities are undertaken in Scotland. We have got to learn a lot more about what Vickers really means and we have to make our
fundamental decisions on which assets go where before we have a good answer to that question.

Q793 Lord Hollick: So your treasury operations are based in London?

Sir Philip Hampton: Yes.

Lord McFall of Alcluith: As a member of the banking commission—your chief executive is giving evidence presently, which people long to hear—we are hearing a number of compelling reasons for separation. Would separation not suit you better if there was an independent Scotland? It would save you the bother of ring-fencing.

Sir Philip Hampton: You mean full separation of the Scottish assets?

Lord McFall of Alcluith: Full separation of retail and investment banks.

Sir Philip Hampton: Possibly. It is premature. One possibility arising from all these proposals, whether Vickers or Liikanen, is that once you have set up completely ring-fenced subsidiaries with their own independent boards of directors, which is the essence of the Vickers proposals, that brings a whole pile of questions about governance and structure and whether or not you have a coherent group or something that really is just two businesses pushed together into a single group, if the subsidiary has really serious independence. That will be a question that all the UK’s banks—indeed, all European banks—will have to address with these structural proposals. It is all right having a single group where synergies are allowed to flow, but once you are stopping synergies you wonder why you are part of the same group. That will be a big strategic issue for bank boards in the future, but I think we are a few years away from knowing that because we are a few years away from the introduction of the measures.

The Chairman: Sir Phillip, unless anybody else has any questions, we have come to the end. Thank you very much for appearing before us, and for covering the wide range of issues that we have thrown at you.

Sir Philip Hampton: Thank you very much.
Scotland Office and Rt Hon Michael Moore MP—Oral evidence (QQ 901-917)

Transcript to be found under Rt Hon Michael Moore MP and Scotland Office—Oral evidence (QQ 901-917)
Scottish Chambers of Commerce, The Scottish Institute of Directors (IoD) and Confederation of British Industry (CBI Scotland)—Oral evidence (QQ 641-658)

Transcript to be found under Confederation of British Industry (CBI Scotland), The Scottish Institute of Directors (IoD) and Scottish Chambers of Commerce—Oral evidence (QQ 641-658)
WEDNESDAY 24 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witness

Owen Kelly, CEO, Scottish Financial Enterprise, and David Nish, CEO, Standard Life

Q601 The Chairman: I am anxious to begin because I know that Mr Nish has to go at 3 pm. Is that right?

David Nish: It is 3.30 pm.

The Chairman: That eases the pressure. Thank you both very much for coming. In the interests of time, will Mr Kelly begin?

Owen Kelly: Thank you for having us. I hope I can add something useful to the Committee’s deliberations. Scottish Financial Enterprise is the representative body for Scotland’s financial services industry. We are a private membership organisation. Our members come from all sectors of the financial industry and from other areas of commerce, such as the law, technology and so on. Our membership is very diverse, reflecting the fact that Scotland is the only financial centre outside London where all financial services are available.

We follow the debate about independence very closely, chiefly in order to ensure that our members are fully informed about the possible consequences and implications of such a major change. We are neutral on the question of whether Scotland should become a country independent of the rest of the UK because, in our view, that is really a political question and one for the voters. However, that does not mean that we are disinterested or uninterested in these matters of public policy that affect our industry very deeply.
We have done quite a lot of work on this. We focused our work on analysing facts and evidence that are available now and can tell us what independence would mean in practice. We do not speculate on what might be decided in an independent Scotland, since we do not think that is knowable at this stage, and we treat with caution all assertions on either side of the argument that are necessarily based on beliefs and expectations about the actions in future of a hypothetical polity rather than on hard facts and evidence.

Our work has focused on five key questions which we think are the most important for our industry. They are: what currency would be used? Under what terms would Scotland be a member of the European Union? What would be the effects of independence on what is currently a wholly single market for financial services in the UK? How long would the transition to independence take, should it be chosen? What would be the requirements for financial regulation on the working assumption that Scotland, once independent, would be a member state of the EU? We do not think that all these questions, or, indeed, any of them, can be answered solely by those who propose and are in favour of independence. We think that the decisive voice on many of them will lie elsewhere, chiefly in London and Brussels. I am very happy to share with the Committee our progress in answering those questions and to deal with any other questions that the Committee has to ask us.

The Chairman: Thank you. We will be asking questions about some of them.

David Nish: First, I thank Lord MacGregor and the Members of the Committee for this opportunity to take part in this session. I would like to provide some context for Standard Life’s evidence today. Standard Life has been based in the city of Edinburgh for nearly 190 years, and we are very proud of our association with the city. Of course, we are here because this is where we were founded but, importantly, we value the business environment that exists in Scotland, and it is a great place to recruit and retain quality staff. Standard Life is strictly non-political. However, we are monitoring the constitutional debate very closely in order to understand the impact on our 4 million UK customers and our responsibility towards helping them plan their long-term financial security. Constitutional change should not be a risk. We also need to understand the effect of other constitutional changes on our 1.5 million shareholders, many of whom are also customers, and our staff, around 5,000 of whom are based in Scotland. We see degrees of uncertainty on both sides of the debate and, as you would expect, we seek more clarity more quickly. The sort of detail we would value in order better to understand the implications for our customers, both current and future, includes such questions as the future tax policy and how it applies to pensions and investments, how the long-term savings and investment industry will be regulated and the level of consumer protection that we can expect relative to what we have today through mechanisms such as the Financial Services Compensation Scheme and the Pension Protection Fund.

There is also a wider policy issue, which is the role of Standard Life and providers in helping to address the significant level of undersaving that exists in the UK, both north and south of the border. We are currently working with regulators, policy makers and industry associations to deliver a sustainable increase in long-term savings across all sections of society, which has led to the recent launch of auto-enrolment into pension schemes. In the event of any further constitutional change, we would encourage careful thought to ensure that the consensus approach to tackling the problem of undersaving that has been adopted is sustained.

Q602 The Chairman: Thank you. On your last point about undersaving, the issue of the long-term future of pension schemes—defined benefits schemes and so on—is one that
many of us in this Committee are concerned about, but it is not one that we can deal with in this inquiry. However, some of the issues you have raised and the questions you want answered are precisely the questions that we will be asking and we will be asking you in return about some of them.

Given that an independent Scotland would use sterling as a currency, do you envisage any arrangement whereby the Bank of England could provide traditional services, such as lender of last resort, to Scottish-based financial institutions? Since the Bank of England is exclusively indemnified for losses by UK taxpayers, how could taxpayers in one country provide financial system insurance to another?

Owen Kelly: I suppose that is one of a number of questions that we probably do not see ourselves as yet being in a position to answer. There are so many uncertainties about how things would work in practice. As I said in my opening statement, we try not to get involved in speculating on what might or might not be decided in future. However, on the specific question of lender of last resort, and if, when one talks about lender of last resort, we mean the provision of liquidity to a solvent bank to deal with a short-term crisis situation at penal rates, it is possible to imagine a situation where the penal rates that are part of that arrangement are a recompense rather than any kind of indemnity. I suppose that is not a million miles away from what the European Central Bank offers to Spain, for example.

On the question of a bailout where there is an insolvent bank and a need to put in taxpayer money, which we have seen with some of the banks based here in Scotland, I think it is extremely difficult to envisage how that could work between two distinct member states of the European Union. We are all aware of the proposal put out by the Scottish Government that there should be a shared central bank and a shared regulator. We would look for more clarity on whether a shared central bank is compatible with the treaties of the European Union, given that they refer explicitly to each member state having a central bank. I am not claiming any special insight into the requirements of the treaties, but we think that is a question that needs to be addressed before we get to the point of figuring out whether it could work in practice to share a central bank in the first place.

David Nish: The only point in Mr Kelly’s response that I would seek to emphasise is the final one about clarity about how the mechanism would work, particularly within the broader European framework and the member states. We see a lot of regulation and the structure of legislation coming from Europe directed towards member states. In my experience, it is a key principle that prudential regulation, oversight and the link to monetary policy tend to be jurisdictional and geared towards the country to which entities and corporations are aligned. That is a very specific question. We need to understand that flow to be able to consider the broader questions that come out of it.

Q603 The Chairman: One of the key questions that we have explored with other witnesses is that if an RBS/HBOS situation arose again, the figures that the British Government would have to provide would be phenomenal and would be a huge proportion of the GDP of an independent Scotland. So there is a very real problem there if similar situations arose. You did not really answer the question about how the taxpayers of different countries would respond. Maybe you regard that as a political or otherwise non-financial question, but there is certainly a very big issue about what could happen.

Owen Kelly: I think the question about taxpayers is a very large one. As we understand the political process that we face, we will have a referendum—that seems to be on the cards—and only after we have had it will we begin the process of answering the questions that, for our industry and many others, are really pressing. That is because, in order to know the
answer to some of the questions put today, we will have to go through a process of negotiation not only with the UK authorities but with EU authorities as well, and, with regard to many other issues, international authorities. So at the moment we are struggling to see how we can treat the propositions that come from those who favour independence as anything more than contingent propositions, highly dependent on a process that can only follow the point of decision. The thing that we are wrestling with at the moment is the extent of that unknowable territory. “How little informed will we be at the point of decision?” is the question that is troubling us at the moment.

Q604 The Chairman: One of the problems is the timetable. We have quite a long period until the referendum vote. We do not know what the vote will be but if it is a vote in favour of independence, as you say, there will be then a long period of negotiation and a lot of these issues will be very material to your industry and could be very unfavourable to it. Is there any concern that this long period will affect your business?

Owen Kelly: There is a lot of interest, and not just in our industry, in understanding how long that would take after a referendum. We spoke a bit about the pre-referendum process of clarification politically, and I think we all understand why the UK authorities do not want to be cast in the role of negotiating ahead of something. I am not sure that they or the Scottish Government actually have an electoral mandate to agree anything anyway; I do not know on what basis that would happen. I am not sure that it was particularly planned this way by people on either side of the argument, but we seem to be in an odd situation. The European Commission has been very clear that it will not say anything definitive, for all sorts of reasons—we could discuss what they are, but they will be obvious to most people in this room. Initially we had four big questions and now we have five, and one of them is how long the transition would take. It is difficult to get hard facts about that, but one hard fact is that the ratification of the Croatian accession treaty will be finished in July and will have taken 18 months. So even after the negotiation, the ratification process alone can take 18 months, if one takes the Croatian example as a model. It is difficult to see how it could be concluded quickly. I do not want to put a figure on it but I know that claims are made that it could be concluded very quickly, even before a Scottish election in 2016. There are a number of facts that suggest something quite different.

David Nish: In many ways, to go back to the points in my statement regarding our customers, and reflecting Mr Kelly’s point, some of these macro issues essentially look as if they are not going to be resolved for a period of time. We as a provider need to ensure that we are giving confidence to our customers regarding the sustainability of, for example, the propositions that we are involved in and the robustness of the organisations that we deal with. These are things that are within the remit of the organisation to be able to control and influence. We have said how strongly we will end up taking an active interest as we have been given to develop an understanding of the impact on our consumers and on the propositions and products that they use. So although I understand your comment around pensions and long-term savings, fundamentally we need to ensure that consumers have confidence in the financial services industry long term so that they end up investing for the longer term. That is beneficial not just for them as individuals but for the economy as we grow and invest.

Q605 Lord Hollick: One of the challenges over the next two years is to furnish as much information as possible to the public. Clearly you have many questions that you need answered from your business standpoint. What steps are you going to take to ensure that that information comes into the public domain? Without taking sides in the debate, it seems
to me that you need to be proactive to make sure that the issues you are most concerned about are brought to the attention of the wider public so that detailed information about your concerns is also made more widely available.

Owen Kelly: I suppose our primary purpose at this stage is to ensure that our members fully understand the implications and consequences of a vote in favour of independence. One of the few facts that we know—well, we do not know this, but it seems quite likely—is that there will be a referendum. So we want to ensure primarily that our members are as fully briefed as they can be on the facts and evidence that we can bring together along with, potentially, our judgment on what the most likely outcome is, if we cannot find any facts or commitments from the political players, and by that I mean UK and EU authorities. In terms of whether we would then see ourselves as having a responsibility to broadcast them more widely, we are an open organisation and we will be very open about the facts that we find, as we are now—we are happy to speak to anyone who wishes to talk about the various strands of the work that we have in hand. Having said that, your point about not taking sides is very important. We are an impartial organisation and do not seek to take any political positions, and we will stick to that.

Q606 The Chairman: “Political positions”, of course, mean that things that could be harmful to your members are ones that you will be lobbying about.

Owen Kelly: I suppose I go back to the question, “Who might we lobby?” Obviously we have regular and extensive discussions with the Scottish Government, but while their policy preferences on matters important to our industry are interesting, because there will be a number of political parties competing in an election in an independent Scotland under an electoral system that I guess will become clear at some point, I do not feel—although I am very happy for things to unfold differently and for them somehow to acquire the capacity to make commitments for the longer term—that, as I understand the process, they are currently in a position to make those kinds of commitments. So in terms of wanting to protect the interests of our industry, were independence to be voted for, we would be looking to the frameworks that come with the European Union as a constant point—the kind of constant enduring framework within which something like that would take us.

Q607 Lord Forsyth of Drumlean: I do not mean to be rude, but you have 200,000 people employed in Scotland. Do you not have a duty to look at these proposals and evaluate them and provide some leadership as to the impact on your businesses? If you say that after the referendum there will be negotiation and, obviously, you want to be involved in that, if Scotland votes for independence that is irreversible. I do not want to be alarmist, but one could paint a picture in terms of not having a lender of last resort and not having a capital base, which means that your members are unable to raise money in the markets here and move their headquarters south, having differential tax rates, which would have an enormous impact on your savings and pension products, and the rest. One can paint a black scenario—but you sound to me as if you are sitting on the fence, almost behaving like a member of the royal family in the political process, desperate not to be tainted with one argument or the other. Yet financial services are the key thing, apart from North Sea oil, and surely the industry should at least be pointing out the questions that need to be answered and holding the feet to the fire of those proposing change that may threaten your members.

Owen Kelly: I understand where your question comes from. Perhaps I should not reject the comparison with the royal family—perhaps I should accept it gladly. This is a highly politicised process. That goes without saying. Our approach is to focus on facts and evidence that we can ascertain now, and some of those facts that we have discovered through that
process carry very evident implications. One fact that we have discovered, which may have been obvious but which was none the less for a time obscured by those who favour independence, was that Scotland would need to have a separate financial regulator. Now we think it is pretty clear under the European regulatory framework that we have to have a financial regulator, so we now have some work in hand to try to figure out what it would mean in practice. As I say, we do not want to make assumptions about what an independent Scotland might or might not decide about financial regulation, but we can look at outlines of cost and other things that will give us a guide for the implications in practice, and we will be quite open about that. If you are suggesting that we should move from there to expressing a view on the referendum question, I think that is a step that we are not currently taking. I would not completely rule it out in future, but that is not something that we are working towards at the moment. But our pursuit of facts and evidence, and our description of them, will contribute to the debate and make very clear what we factually know the consequences of independence are for our industry.

Q608  The Chairman: Let me give you an example. We are coming on to it in more detail in a moment, but the issue of the lender of last resort and financial institutions could have major implications for your business and your customers. Would it not be right for you to point that out now? Certainly some of our witnesses have.

Owen Kelly: Absolutely. That is one of the many questions that we have raised—with the UK authorities and with the Scottish Government. I am assured by the Scottish Government that they will put something out before Christmas, which they call a macroeconomic framework. It has probably been discussed before this Committee before; it is being prepared by a group that is a sub-group of economic advisers. They are saying that is when all will become clear and they will then explain how the central bank and so on will work. We look forward to seeing that and we will evaluate it and it may well raise further questions. But I hark back to this—that if one were looking for certainty about how lender of last resort would work, to take that as an example of one aspect of a very complex picture, I am not sure that we could see their assertion of how things could work and their propositions as a conclusive answer. That can come only from some sort from discussion with the UK authorities.

Q609  Lord Tugendhat: We are looking into the implications of Scottish independence for the United Kingdom as a whole. You have Scotland-based Scottish companies, but the vast majority of your clients are in England, Wales and Northern Ireland. We are dealing with a lot of uncertainties, as you yourself said; we do not know what the outcomes will be but we know that some of them will have a profound impact on your business. Do you not think that you have a duty now to begin to inform your non-Scottish clientele and customers of the implications of what is being talked about? I am no longer a policy holder with Standard Life—I am too old for that—but I had a good experience with you earlier. But if I was still one, I would expect to hear from you about the potential impact on my policy of what is happening in your part of the United Kingdom.

David Nish: The key thing that providers such as ourselves should do is to act responsibly towards their customers, and part of acting responsibly is not to get engaged in hypothetical discussions or hyperbole. That is one of the difficulties at the moment. In Lord Forsyth’s last question he used the word “proposals”, but I am not aware of any clear proposals that go to the heart and allow us specifically to comment or analyse. What we are doing is giving our customers the confidence that we will engage and do engage with the political parties as regards the issues that we see coming through—I mentioned some today—such as financial
compensation schemes or the effect of the taxation structure across the UK. One thing that consumers in the UK benefit from at the moment is the consistency of a single geographic market as regards taxation, regulation, employment policy and social policy. I will come back to pensions. We have seen two major developments. We will try to bring 11 million more savers into saving over the next six or seven years. It will be government-driven, through NEST, and at the individual pensions level. So one thing that we have assured our customers about is that we are going to be an active participant as the debate develops. At the moment, all we can do is to highlight to the parties and to those who are campaigning the issues that need to be resolved. Some of them go through trade bodies, such as SFE or the Association of British Insurers, at a national level. If consumers want to engage specifically with us, we engage specifically and give out what we know. But engaging in things that we do not know is not going to instil anyone with confidence.

Q610 Lord Tugendhat: I think that you are going to find that the sort of people who write for the newspapers about personal financial advice will start raising those questions in their columns, and the people who read the newspapers and seek advice on whether they should have a policy with you or somebody else will do so. If my personal pension was coming up to maturity now and I had to decide who I would take annuities from now—I had to take those decisions in the past, so I am with who I am with—I would be interested to know the potential position of Scottish-based as opposed to English-based organisations.

David Nish: If I look at the position today, let us discuss prudential regulation. Last week, the Prudential Regulatory Authority—part of the Bank of England, as it will be—issued a discussion paper on insurance regulation. That is framed in the context of the definition of jurisdiction being the United Kingdom. That is the definition that we are all working with today. There is no change to that definition. We focused very strongly as an organisation during the past two years on capital robustness for a recognised format, a recognised customer service. From my point of view, our taking responsibility for paying attention to allowing our consumers to be conscious of the consequences of any constitutional change is what we can do better at the moment.

Q611 Lord Levene of Portsoken: Good afternoon. It has been suggested that an independent Scotland might pay a premium to the Bank of England to provide lender of last resort facilities, just as with any other insurance programme. Do you think that this is plausible? Given the vast size of Scotland’s banking sector assets to GDP, do you think that such a premium would have to be enormous? Without paying a premium, how would you expect an independent Scotland to cover the contingent liabilities which inevitably arise from the financial sector?

Owen Kelly: I think, as I explained earlier, that if we are talking about lender of last resort for liquidity reasons, the transaction, if you like, would cover certain costs. To clarify the question, are we talking about bailout?

Lord Levene of Portsoken: Not really, because it would be on an ongoing basis. If it was wanted that the Bank of England stood behind it, one would imagine that, as it would be in another country, it would expect to receive a commercial return for reciprocating.

Owen Kelly: For providing a service. I am not aware of any example of that sort of arrangement.

Lord Levene of Portsoken: Of course, because you would not expect a central bank of country A to guarantee the liabilities of country B.
Owen Kelly: No, I think that is right. I appreciate the desire to clarify these questions. All we have to go on at the moment on how that might be achieved, from any public authority presenting a case for that approach, is that we await the Scottish Government’s publication of its macroeconomic framework, where they say that they will explain those things. Like you, I am not able to think of a way to do it myself.

Lord Levene of Portsoken: With respect, my question was: if that were carried out as a commercial transaction, would you expect them to pay a fee and would it be a large fee?

Owen Kelly: I am not trying to evade the question, but I do not know, because it would depend so much on the negotiations that would create such an arrangement. Also, I do not know what model is being proposed because it is yet to be put forward, but in theory I agree with you, it is certainly a major question.

Lord Levene of Portsoken: But your members in SFE clearly regard that as a very important question, as they need to know that they would be backed up.

Owen Kelly: Absolutely, yes, which is why we have posed it in every way that we can and continue to do so, mainly in private, but in public as well.

Q612 Lord McFall of Alcluith: On the issue of financial regulation and the issue of the PRA being a single pan-UK body, David, do you see a difficulty with that, given that the PRA is a UK taxpayer-funded body so that, at the end of the day, the PRA would have both responsibility and liability for institutions in Scotland and could promote recklessness in institutions in Scotland to grow beyond the Scottish tax base because, at the end of the day, the UK taxpayer will be bailing them out?

David Nish: Again, I apologise for not going into the hypothetical nature of the question. As regards my experience of regulation around the world, there appear to be two key principles. One is that prudential regulation tends to be country-specific and specific to organisations within countries. I am not aware of examples of cross-border prudential regulation. You then tend to find that conduct regulation is with the customers related to the market there. So you could have the issue of cross-border legal entities. I look on the question as being: how do you get that alignment between the understanding of what would happen in the economy at large, the policy framework at large and the regulations applying to the entities that operate within it? As I say, I do not have any experience of where that prudential and macro-fiscal policy crosses borders. I do not think that there is a working model that I can find.

Lord McFall of Alcluith: I do not want to get into the hypothetical, but in terms of practical business experience, day-to-day experience, does that make it more difficult?

David Nish: Again, I would prefer to have more straightforward relationships—that is, one to one. If you end up with three in a relationship, you have to work around a triangle. We would need clearly to understand that if there was a proposal along that line—that there would be a derogation from Scotland to the rest of the United Kingdom, as was—it is not just what happens on day one but what happens as the future develops. One thing that is difficult to understand is the stresses and strains that are then placed on the system. There has been experience of that. If you look back over the past three or four years, countries have had to do things to protect entities within their country and their economy. How does that work in a situation where you have a multi-jurisdictional approach? That might add an additional strain, so it is a strong question that needs to be answered: can that be achieved by prudential regulation?
Q613 **Lord Hollick:** You raised an important issue about cross-border regulation. The proposed European banking union would provide just that. If you look at the non-banking sector, how would you like to see that develop were Scotland to decide to go independent? How would you like to see the insurance industry regulated so that you as a Scottish-based but international business—I guess the majority of your customers are outside Scotland—

**David Nish:** Correct.

**Lord Hollick:** As Lord Tugendhat has said, what would be an ideal? This is another hypothetical question, I am afraid, but what from your point of view would be the ideal and simplest way forward in those circumstances?

**David Nish:** The thing that is really important is how we ensure that end customers are confident in the organisations that they end up transacting with. That is where this whole thing lies, ultimately, with prudential regulation. Customers today understand that businesses such as ourselves are regulated; they understand that there is an oversight regime, and that there are mechanisms in place that we can go to if they have issues with organisations, whether that is the Pensions Regulator or the Financial Ombudsman Service. So you have to ensure that what is in place is a full framework that takes the end customer very much in mind. This is obviously not me talking about Standard Life, but certainly over the last three years it is very much the individual man in the street who it ends up having the greatest impact on, as regards failure in the financial system. In constructing financial regulation, you have to take account of how the corporate aims are surviving, in the context of living wills, and so on. But it has to be about how you ensure that the individual is confident when contracting for the longer term. So there needs to be real clarity over rules and an ability to see direct access—how the customer can get access through to resolution of particular issues. There has to be this alignment between prudential and conduct regulation; you cannot have one without the other. I agree that what is happening with European banking at the moment is that we are trying to put in place a cross-border situation, but you are also seeing in the early days some of the issues around trying to do it cross-border. You have to take into account the local situation and the impact on the economy locally versus the macro picture, and we have not had experience of operating that way.

**Lord Hollick:** Your competitors are based to a large extent in London, so would you be comfortable with a situation where you had a different regulator or would you prefer to have the same regulator?

**David Nish:** I have different regulators all round the world, in a sense, in the markets that I do. What I benefit from today is from having a single regulator in a geographical area. The issue is the change and the impact of the change—and because the definition is not there. Again, when we look through the whole range of things affecting the individual customer’s decision, whether it is regulatory oversight or the tax regime, with the introduction of differential tax, or doing it cross-border, the proposition, when one is put forward, has to be very comprehensive. A lot of these things are not just single issues around whether there is a sole prudential regulator; it has to effectively cut across, particularly in the savings agenda. It is about social and employment policy as well as regulatory issues.

Q614 **The Chairman:** I am being very naive about this because I have not really thought about it very much, but does that mean that the vast majority of your customers in the rest of the UK will ultimately be dependent on the view that they take of the prudential regulator in Scotland and how it manages your business?
David Nish: There are two things that our research of customer needs have shown consistently and strongly. One is satisfaction of expectations, and the second is the robustness and sustainability of the organisation they transact with. These are relationships that take place over multiple decades, so we can see it from the point of view of the individual having confidence in the organisation. That is why I look on the potential consequences of the constitutional debate as it goes forward as being very much about these two things—the confidence of our customers and the competitiveness of my business. Therefore, as the proposals are developed, we will be able to understand better the impact on those two issues and the actions that will need to be taken.

The Chairman: In terms of the financial compensation scheme, and in the case of a split between the rest of the United Kingdom and Scotland, would your customers in England be dependent on a financial compensation scheme in Scotland or would it be the existing one?

David Nish: Again, hypothetically, if you look at the businesses that exist in Scotland that have such a long history, I do not know how you would end up separating those businesses. Again, it is a very similar type of discussion as the one about having cross-border regulation. You would need to evaluate how such schemes would be established. These schemes are paid for from the industry; they are socialised costs. So to be able to evaluate that, you would need to evaluate the financial services industry on one side and the premiums collected relative to the base of business that the schemes have effectively been guarding against.

Q615 Lord Tugendhat: Just briefly reverting to a previous line of questioning, I have great sympathy with you in your position, as you are running very complex businesses. You have customers all over the United Kingdom and all over the world, and you have a lot on your plate. Uncertainty is a very difficult thing to have to deal with. But the more I listen to you and the more I hear you say what you do not know—and it is not your fault that you do not know—and the more I hear you saying how important the issues are that you do not know and how profound the implications are of what you do not know for the customer, as somebody who is not Scottish and not resident in this country, it would make me pause for thought before doing business with you for my long-term financial commitments as compared with a company, whether based in London or Canada or elsewhere, which I reckoned did know about these important things. I think that you are being put at a real competitive disadvantage.

David Nish: I would hope in a sense, particularly given the attention that we pay to the consumers’ advisers, that what we very much focus on is getting across that strength. Jurisdiction is only one thing that gives rise to the confidence that someone would have in an organisation, and the sustainability that you end up with. So it is very much about us being very mindful of this debate. On the questions that are being asked, I look on a lot of these as the duty of politicians to define the environment in which companies operate. We are very much trying to work in support of a consensus policy that is quite fundamental. So it is a duty on politicians on both sides to get some definition here around some of these big questions, which have been in existence now for at least the last 18 months.

The Chairman: The initiative is coming from one side, of course.

Q616 Lord Forsyth of Drumlean: I do not want to break ranks with the trade union of politicians, but I suspect that quite a lot of politicians may not have the expertise or knowledge not just to answer the questions but to determine what they are, which goes
back to the point that I made about providing a lead. At Standard Life, what kind of costs do you have in meeting regulatory and compliance regimes now?

David Nish: I do not have that specific answer, but I shall take that question away. One reason why this is quite difficult to do is that everything we do is regulated. If you allocated parts of my time in the past week, you would find that I probably spent 20% of last week in engagement with regulators. So from that point of view it affects everything that we touch and do, because that is very much the environment in which we operate. I will try to give a thoughtful answer.

Lord Forsyth of Drumlean: You can see where I am going with this. As I understand it, if Scotland were an independent country and it had joined the EU, it would be required to have its own regulator. It would be contrary to EU law for Scotland to have a shared regulator. I see heads nodding in agreement. That would mean that you would end up with two regulators. One of those regulators would relate only to a small proportion of your customers because they would be beyond the Scottish border. I do not know about nationalised companies, but I do know about banking. In banking, the costs of compliance with regulation are absolutely astronomical and compliance officers seem to have become the biggest growth industry of the past 10 years. That presumably would mean that you would see a substantial additional burden to your costs. Would that not make you less competitive than firms that are based south of the border with only one regulator serving where the bulk of your customers are? If that is the case, would there not be a gravitational pull to take you across the gradient that is represented by the Scottish border and therefore to move operations south?

David Nish: As I said to begin with, there are only two real criteria I am using to assess the ongoing debate. One is the confidence of consumers and the other is the competitiveness of Standard Life. The competitiveness of Standard Life will be considered across a whole range of potential metrics that include the costs of doing business. I cannot prejudge at the moment, but we have no desire to go through a large restructuring. In some ways we have experience of that from six or seven years ago with the demutualisation. It was an expensive business because changing anything is an expensive business. As an example, under the Scotland Act, if there is a local income tax, we would have to deal with potentially a local state pension deduction. That could easily be a £2 million to £3 million bill on IT for 250,000 to 500,000 pensioners’ operating costs each year. All these things would be taken in the round. It has to be in terms of the costs of change versus the question of whether there is a benefit attached to divergence. At the moment the evaluation of these matters cannot be done. All I know is that change tends to drive up costs.

Lord Forsyth of Drumlean: Just on the point of costs and the regulator, while I do not want to open up old wounds I seem to remember that, with Standard Life, the FSA took a particular view on how you should organise your business, which I think did a degree of damage to you. So it is not just the costs of compliance. If you have more than regulator, they may have a difference of view on capital requirements or what is going to happen in the market or what the right balance of investment should be between equities, bonds and so on. Does all that not make your business less competitive? Is it affecting value in terms of your ability to raise capital because it creates more uncertainty for those businesses that are based in Scotland?

David Nish: As I have said, the more you introduce complexity, the more likely it is that costs will increase. That is one aspect of the competitiveness debate. What the impact would be on the rest, I would have to speculate, and I am not going to do that. At the end of
the day this is something that we will keep under review with close supervision. We are going to take account of it so as to ensure that we are giving our customers best value. As you raised Standard Life’s past, hopefully the Committee will recognise that in the past six or seven years since demutualisation we have been recognised as one of the strongest capitalised within the sector.

**Owen Kelly:** Could I briefly add something? The point Lord Forsyth is making about the additionality of the regulator is important in that if a large proportion of your customers are in a future market comprised of England, Wales and Northern Ireland, you still need to be regulated there. If you have also a regulator at home, it is additional. That is an important point. We are working now on trying to assess the implications of that in terms of costs.

I would also point out that our industry is very diverse. There are different kinds of operations which are affected in different ways. For example, let us say that you are in the business of fund administration or asset servicing and you have an operation not only in Scotland, but also one in South Africa, one in Dublin and one in Hungary. If you want to make some assumptions about the future fiscal and regulatory choices made by an independent Scottish Parliament, it is possible to imagine that it might not make all that much difference because the regulatory jurisdiction you are operating in is not so central to your business model. Another aspect worth touching on is that at the moment the FSA requires some operations to be carried out in the jurisdiction. For example, if a Spanish bank owns a big UK business, it has to have certain things in the jurisdiction governed by the FSA, so again it is likely that you would see some pressures for reconfiguration if a new regulatory jurisdiction was introduced. As I say, we think that under the EU regulatory framework, that is a consequence of independence.

**Q618 Lord Tugendhat:** The possibility of a referendum has been in the air for a long time, and of course the victory of the SNP in the last election made it a certainty. I am sure that you have had an opportunity to look at the experience of other countries. In particular, I wonder what conclusions you might draw from Canada. My impression is that there was quite a migration from Montreal down to Toronto and elsewhere, and I do not know if Montreal has recovered the position it held before. Would you have any fears that such a situation could occur here in terms of the uncertainty we have been talking about? That obviously must be a great concern to you. Might it provoke something similar to what happened in Canada?

**Owen Kelly:** I think I can say quite safely, in relation to our members’ focus right now, that although people may get impatient with us, it is a question of looking at what you can do to find out the facts and the evidence that will allow us to understand the implications and the consequences. Depending on what those facts and evidence tell us, it is theoretically possible that that could lead to certain conclusions being reached, but at this point I do not think that any of our members are reaching views on that sort of subject. I must admit that while I know a little about the Canadian experience, I do not know a sufficient amount to judge what was known in advance of that referendum. I just do not know if it was a vote on a clearly defined prospectus or whether there was a degree of uncertainty in it.

**Q619 The Chairman:** I know we have to finish very soon but, just reflecting on the discussion that we have had, I can quite understand your desire to have clarification, particularly from the Scottish Government, as to their views and what they would wish to negotiate for in terms of a number of the issues that we have discussed, but, as I understand it, that is not going to happen for some time. I would have thought that you would have to have a clearer view and be pressing the Scottish Government in particular—since it is their
Scottish Financial Enterprise and Standard Life—Oral evidence (QQ 601-622)

initiative—regarding the kind of solutions that you would like to have to some of the issues that you are raising.

Owen Kelly: Actually I am not sure. As I think I said before, we have never thought that the Scottish Government would provide the authoritative voice on many of these questions. If one thinks about—it has been in the news over the past couple of days, of course—the question concerning the terms of entry to the European Union, the great debate there, among many other things, is whether Scotland, if it became independent, would inherit the UK opt-out on the euro. That is specifically regarding entry. It seems to me that the authoritative voice on that will be the member states of the European Union. I have put it to UK Ministers that they might engineer a way of obtaining a clear steer on that question from the authoritative voice. The Scottish Government, it seems to me—I venture this as much on a personal basis as on anything else—are clearly wholly committed to winning the referendum. So whatever they say, one has to see it in that context. It is aimed at persuading—and I think, to be fair, that they might agree with that—rather than presenting an authoritative, conclusive and factual conclusion. It seems to me that can come only from the EU and, on some issues, from the United Kingdom Government. I would not want you to think—in fact, I would reject the thought—that we are waiting for the Scottish Government to tell us things, because I struggle to see how they would have the authority to do so.

Q620 The Chairman: I was not going to ask this question but, in view of what you have just said about the time you have recently been spending in the EU, I shall do so. The reforms being discussed in Europe, including a single financial regulator, market reforms and access to emergency funding from the ECB, are likely to strengthen the case for an independent Scotland becoming a eurozone country in the near term, because you would have those certainties of them sharing a common central bank rather than having to depend on the Bank of England. Is that a ridiculous thought?

Owen Kelly: I certainly do not think it is ridiculous. Obviously people are working in Brussels and talking from Brussels, so they will present the view that in a few years’ time everything will be sorted and the euro will be a highly attractive proposition, with everyone queueing up to join. However, a decision like that could only be taken after independence.

Q621 Lord Levene of Portsoken: This question is really of interest to Owen Kelly, for reasons which will be obvious. I want to go back to the question you were asked before about whether you, as the trade association for the financial services industry, which is the first or second industry in Scotland, should not be much more forthright in standing up to be counted. I can understand why an individual firm would not want to do that, because they might see some backlash. But if this decision goes—from what you have been saying this afternoon—the wrong way, it is irreversible. After that, if your members say, “Oh dear, we’ve got a terrible problem. Why isn’t anything happening?” you might say, “Well, you asked us not to say anything”. Is nobody asking you to stick your head above the parapet?

Owen Kelly: At this stage, people are asking us to find out facts and get any answers that we can so that we know, as clearly as possible, what the consequences will be. I am sure you will be much more familiar with this perspective than I am but, from the point of view of a company that, say, is perhaps not even a UK company, there are ways of managing a situation like this that need not involve taking a public stand of any kind or indeed expressing a clear view at all. So in answer to your question on whether we are under pressure to take a stand, I would argue that we are absolutely taking part very publicly and very fully in the
debate but on the basis of pursuing questions and obtaining facts and evidence. I again emphasise that we do not solely direct those questions at the Scottish authorities.

Lord Levene of Portsoken: So thereafter you can come back for a second bite at the cherry, if you want to, when you have all the facts.

Owen Kelly: Possibly, yes.

Q622 The Chairman: Or possibly that is too late in the sense of, rather than just asking questions and trying to establish facts, putting forward very clear recommendations as to what is in the best interests of your industry in terms of the policies to be pursued in the context of a yes answer.

Owen Kelly: In terms of participating, if there is a vote in favour, many of us will want to participate in the decisions that follow from that.

The Chairman: I know that Mr Nish has to go. Thank you very much indeed for being with us. It has been a very interesting session and it has given us lots to think about.
The Scottish Institute of Directors (IoD), Confederation of British Industry (CBI Scotland) and Scottish Chambers of Commerce—Oral evidence (QQ 641-658)
Memorandum submitted by SSE

1. SSE (formerly Scottish and Southern Energy) is a UK owned and based utility with a core focus on the energy markets in Great Britain. It is the second largest energy supplier, supplying over 9 million customers. It is also the second largest generator of electricity in the UK, and the largest generator of renewable energy. SSE also operates the electricity distribution networks in South Central England and the North of Scotland, where it also operates the transmission network.

2. The following statement is evidence that SSE submitted to the Scotland Office, the Scottish Government and the Economy, Energy and Tourism Committee of the Scottish Parliament.

3. SSE has no wish to become involved in a constitutional or political debate. This submission should be considered in its entirety, and SSE will not be adding to it with on- or off-the-record comment to any stakeholders.

Statement

4. SSE has considered the practical implications for its businesses of the consultations issued in January 2012 by the UK Government and the Scottish Government and they are set out below. In doing so, SSE is mindful of the fact constitutional arrangements are matters for voters.

5. SSE employs people, serves customers, owns and operates assets and has plans to invest in England, Wales, Scotland, Northern Ireland and the Republic of Ireland. It expects to continue to be a significant business in England, Wales, Scotland, Northern Ireland and the Republic of Ireland in the short, medium and long term and has a legitimate expectation that its investments in existing assets will continue to be adequately remunerated. SSE has no plans to move its Registered Office from Perth.

6. SSE believes that the interconnection and integration of the electricity and gas systems and markets in Scotland and in England and Wales should continue regardless of the outcome of the referendum on Scotland’s future. This means that there should continue to be a single energy market for the islands of Great Britain, just as there is a single electricity market for the island of Ireland. Indeed, SSE supports further harmonisation of energy systems and markets to strengthen security of supply and achieve efficient use of energy resources for the benefit of customers.

7. SSE has long acknowledged, most recently in its Annual Report 2011, that regulatory change and legislative change, of which the current proposals to reform the electricity
market in Great Britain are an example, are among the principal risks it has to manage, and it has extensive experience of doing so.

8. The forthcoming referendum, however, increases the risk of regulatory change and legislative change with regard to the electricity and gas industry in Scotland because it means there is additional uncertainty about the future. This additional risk will apply up to the date of the referendum and, should the result be a vote in favour of a change in Scotland’s status, will continue until there is a binding agreement on all of the issues that could affect the electricity and gas industry in Scotland.

9. This is because under the existing arrangements investment in new long-term electricity and gas assets in Scotland and England and Wales is effectively remunerated through the bills paid by electricity and gas customers throughout Great Britain. These arrangements were established by the United Kingdom Parliament, and Ofgem regulates electricity and gas markets in Great Britain.

10. New arrangements would have to be established in the event of Scotland deciding it would no longer be part of the United Kingdom and becoming independent. Determining those arrangements would be just one aspect of the extensive negotiations between the Scottish and UK governments which would follow. In these negotiations no issue, including the electricity and gas industry, would or could be looked at in isolation from all of the others.

11. Moreover, there does not appear to be a consensus on how Scotland’s position with regard to the European Union, which has a major influence over electricity and gas systems and markets in Member States, would be determined in the event of a referendum result in favour of Scotland ceasing to be part of the United Kingdom.

12. To be sustainable, all investments have to be adequately remunerated and additional uncertainty about key issues such as regulation and legislation makes decision-making in long-term businesses more difficult. This means SSE has a responsibility to consider the risks to adequate remuneration when making investment decisions concerning any operations and assets, including those in Scotland. Its policy, most recently described in its six-month financial results statement published in November 2011, is to apply where appropriate a risk premium to the level of remuneration expected from individual projects.

13. The practical application of this policy means that when making final decisions with regard to possible new investments in Scotland, which will have to be adequately remunerated if they are to be made, SSE will have to decide whether the additional risk of regulatory and legislative change with regard to Scotland means it should apply a risk premium to the investment proposal. If it concludes that a risk premium should be applied, it will have to determine what that premium should be; and, if a risk premium is applied, it will have to assess the impact of that premium on whether or not to proceed with the investment proposal.

14. Making investment decisions is about striking the right balance between risk and reward. The additional risk of regulatory and legislative change does not mean that SSE will not invest in projects in Scotland while its future is being determined. The development of SSE’s existing projects in Scotland will continue as planned. It does mean, however, that the additional uncertainty represents increased risk, of which SSE will have no alternative but to
take account in making final investment decisions on those projects while that additional uncertainty remains.

15. It does not mean that anyone should seek to attribute to SSE a view on whether or not Scotland should remain part of the United Kingdom: SSE does not believe it is appropriate for it to have a view on that question, which can only be answered by voters.

October 2012
Scottish Trades Union Congress (STUC)—Oral evidence (QQ 659-675)

Evidence Session No. 13.  Heard in Public.  Questions 659 - 675

THURSDAY 25 OCTOBER 2012

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

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Examination of Witnesses

Dave Moxham, Deputy General Secretary, Scottish TUC, and Stephen Boyd, Assistant Secretary, Scottish TUC

Q659  The Chairman: We are one member short, but we ought to begin. My apologies that we have run over. Perhaps we may do that with you as well if necessary, because the issues are very important. We are extremely grateful to you for coming today. As you know, we are focusing solely on the economic implications of the issue, and it is very important that we hear your views. Would you like to make a statement or shall we go straight to questions?

Dave Moxham: Perhaps very briefly. Thank you very much for the opportunity to come and speak to you. It is very helpful to us, given the approach that we are taking on this question, to have an inquiry that is focused on the economic impact. Because our organisation has 640,000 members, it is very hard to take a view about how people might feel emotionally and in terms of identity about this issue. The best service that we can provide to our members, and hopefully to wider society, is to focus in some detail now and in the coming months on the economic impact, particularly on our members.

Q660  The Chairman: The first question is: what does the STUC see as the main economic implications if Scotland becomes independent? Do you have a view yet on the balance of economic advantage to your members?

Dave Moxham: We certainly have not taken a final view on the overall balance. We continue to work on these questions in some detail. I should mention that our General
Council will produce an interim report. We have undertaken a series of consultations with our members and other organisations over the past couple of months. Although we will not come out in the interim report with a yes/no position, we hope to have some red, amber and green positions on some of the key issues. We will look at three areas, and we are happy to comment on them in more detail. The first is the division of resources and the relative fiscal position of the newly independent Scotland. The second is the type of powers that we believe would be adopted by an independent Scotland, and how they might be used. Thirdly, we will look at some of the specific sectoral impacts as they affect our members.

Q661 Lord Tugendhat: If Scotland becomes independent, some of the UK’s stock of assets and liabilities would have to be divided. What would you see as being the most important economically for Scotland? What would be your guiding principles in making the division? Finally, are there any particular items to which you attach special importance?

Dave Moxham: It is difficult not to start with oil and gas. We are making a presumption that an independent Scotland would have a geographical share of North Sea oil and gas: that would be the basis on which to divide the spoils. It is difficult to extend that principle across all the different assets. One would imagine that with respect to some physical assets such as schools and other buildings, it would be relatively simple to adopt a geographical approach. It strikes me that that would become more difficult with debt liability. One presumes that it would be based on a per capita approach. Then there is the issue of the banks, which we may come on to discuss. One particular issue for our members is how pension liabilities will be divided, with respect to the schemes themselves and obviously the state pension.

The Chairman: Public sector jobs is another issue.

Dave Moxham: That is an issue for us. Looking at the demography of public sector jobs, it is relatively easy to imagine how the continuing need to fund them would be divided on the basis of the current devolved settlement. When it comes to the largest number of reserved jobs, which is essentially the Civil Service, that is a slightly more complicated situation. The analysis of the ONS suggests that Scotland has about 9.6% of Civil Service jobs, against a population of 8.5%. Obviously, public spending is higher in Scotland, so the figures would appear to tally. However, there are specific centres of activity in the Civil Service. We have a disproportionate number of jobs in the Student Loans Company and the IRS, but probably less than our per capita share in the DVLA. So there would be regional and sectoral impacts on workers. Our affiliated unions are working through some of those potential impacts and we are certainly alive to them.

Q662 The Chairman: Are you looking in particular at the question of public sector pensions?

Dave Moxham: At this stage the view that we have taken—I am not sure how much detail you want me to go into—is that we can split the various public sector pension schemes into three distinct areas. The collection of local government pension schemes that make up the LGPS in Scotland is essentially a funded and devolved scheme. We do not imagine particular problems with that post-independence. There is a second set of schemes—I will avoid using acronyms—for teachers, the NHS, the police and the fire service. They have a measure of devolution; their actuarial valuations take place in Scotland and are distinct. However, the overall underwriting of the schemes is still currently a Westminster UK Treasury function. One would imagine that, with difficulty—though it is not impossible—before looking to share the spoils, one would look at actuarial valuations as the basis for that. I am not suggesting that that would be easy, but I think that that would be the methodology.
third scheme is the Civil Service scheme. In terms of UK liabilities, it is the same; actuarially it is not valued differently in Scotland from in the rest of the UK. That would obviously need additional work.

Q663 Lord McFall of Alcluith: How would current joint public expenditure flows, including social security payments, healthcare, Barnett transfers and defence spending be affected? What views do you have on that?

Stephen Boyd: I think that they would undoubtedly end with independence.

Lord McFall of Alcluith: After independence, would you like the joint arrangements to continue in that area? Have you given thought to that?

Stephen Boyd: In terms of what?

Lord McFall of Alcluith: In terms of how the payments are made. Would you like joint arrangements between an independent Scotland and the rest of the UK to continue?

Dave Moxham: With regard to the state pension, for instance, there would be difficulties if the arrangements did not continue. At the moment we have circumstances in which overall responsibility for the payment of the state pension is a UK function. Were there not to be any joint arrangements, one imagines that there would have to be a snapshot decision that residents in Scotland would be provided for by a new Scottish welfare system, and residents down south by the welfare system for the rest of the UK. That would present some potential difficulties—not least, would the money follow the person, as is the case now with pensioners in Europe, or would the rest of the UK adopt the responsibility for pension payments to somebody who has moved south of the border? Some arrangement would need to be made.

Lord McFall of Alcluith: So you would be quite happy with separately negotiated pay awards? Do you see any implications of that?

Dave Moxham: It is possible to imagine, with economies diverging at some point in the future, that pressures for different negotiated settlements might present themselves. Generally speaking, we tend towards the view that the more similar the industry, and the more similar the economic conditions in which it operates, the better it is for us that the negotiations should take place at the highest level possible.

Lord McFall of Alcluith: Do you have any view over the longer term regarding Scotland’s geographical claim to oil revenues, with Barnett transfers being discarded? Would Scotland be more prosperous?

Dave Moxham: Well, we have been pretty frustrated thus far with the low quality of the debate, back and forth between the protagonists of the yes and no campaigns. There are two figures being mooted. The first is the no campaign figure that assumes a large Scottish fiscal deficit. That is true as long as one does not take account of the GVA produced by the geographical share of oil. The counterargument from the yes campaign assumes that every individual will be £500 better off, without taking cognisance of the fact, first, that we have to include the deficit and, secondly, that this is a snapshot of 2010-11, and that income derived from oil is at best uncertain and probably on a downward trajectory.

Q664 Lord McFall of Alcluith: Given the challenge I made to the previous witnesses, would you be happy as an organisation to participate in ensuring that we have an evidential campaign, with people working together to ensure that they get the facts out? Do you think that that is missing?
Dave Moxham: Absolutely. My colleague may say something about the quality of the data that are out there. Frankly, with respect to the relative fiscal positions, the first thing we need to do is get people to stop arguing about this in extreme political terms for their own advantage and concentrate on the things that are available through GERS and other data sources.

Stephen Boyd: It is very important to stress the degree to which we have been frustrated by the quality of the arguments on this point presented by both sides. This extends beyond the political sphere. The contributions made by both the academic and media sectors have been extremely dispiriting. Hopefully this will change over the course of the current year. Various research centres are doing important work on the economics of independence. At the moment we are being held back by a serious lack of evidence. The capacity of the media in Scotland to engage properly with these issues is almost diminishing by the week. There are few economic commentators of any stature. All this combines to produce a debate that is highly political and not evidence-based. Hopefully we will see an improvement in the current year. Sorry, I should have emphasised that our organisation absolutely wants to be at the forefront of making sure that the quality of the debate and the evidence is as high as possible. It is also important to stress that although we try to overcome resource problems in this area, the capacity of many civic society organisations to examine the issue of Scottish independence is pretty constrained. I listened to my colleagues from employer organisations in previous sessions and it seemed that none of these organisations had any analytical capacity. This is something that we should all be aware of and concerned about.

The Chairman: I think that we would agree with that. Our contribution is to try to shed light on these matters as well.

Q665 Lord Levene of Portsoken: When I ran defence procurement in the Ministry of Defence, the number of journeys that I made to Scotland and the number of contracts we had here were very high. I do not recall that we calculated what proportion of our expenditure went to Scotland. If we had, I think we would have found that it was heavily weighted in Scotland’s favour. There was no reason for it not to be. Much of that work also relates to the nuclear submarine facilities here, on which we spend an enormous amount of money. Moving them would have enormous implications for jobs. If the Scottish Government’s policy at the moment to exit from nuclear submarine facilities goes ahead with independence, those jobs—in my opinion, quite a large number—would be lost. The effect of that, coupled with the effect on the sale of equipment from companies in the Scottish defence industry to the rest of the world, which is very much promoted by the MoD, would be quite substantial. The Scottish defence industry is a very important player in the world market. How would you think that those jobs could be replicated, particularly ones in the nuclear area that are fairly labour-intensive?

Stephen Boyd: I think that it would be tremendously difficult to replicate those jobs with others that had similar skills levels and wages. We have to be mindful that although a lot has been said about various sectoral impacts, when it comes to defence, we have to be clear that defence procurement tends to be driven by two processes. The first is to try to distribute spending in a socially beneficial way across countries—you might refer to that as pork barrel in America, if you are being unkind—but also by technology ownership. If you look at some of the current companies in Scotland, the multiplier from R&D spending—for instance ****—makes these very important jobs in Scottish manufacturing industry, when it comes to maintaining a critical mass in Scottish manufacturing, including high-level skills. In order not to take up too much of the Committee’s time, I would refer you to the cross-party submissions in response to the defence strategy review a couple of years ago. The context
set out at the start of that document highlighted the genuine economic importance of defence jobs across Scotland. That is an area to be mindful of and concerned about. The uncertainties round that are what the EU and the Scottish Government might do about forthcoming defence spending. Will it be used to try to directly recreate lost industrial capacity? If so, there are a number of challenges there in terms of designing a successful strategy. We would have to be mindful of the fact that such an interventionist strategy has not been pursued on the Scottish or UK level for some years, so the challenges would be very serious.

**Lord Levene of Portsoken:** Many of those jobs are highly specialised and would be required in the UK if Scotland decided to exit the nuclear scene. That would probably mean that the individuals performing those tasks would move away. They would move south and there would be no cause to replace them because the requirement would no longer be there. Does it concern you that you would have a significant net loss of very skilled labour?

**Dave Moxham:** Perhaps I may come in there. I think that there is a potential distinction to be made between jobs that might be lost as a consequence of the removal of Trident from the Clyde, and the wider possibility that the whole of the Faslane base would go, with its Astute class submarines and various other things. As my colleague said, some of that would depend on decisions that the Scottish Government took with a view to their future defence budget. We have estimates in the public sphere this week of a reduction in spending of anything up to £1.5 billion, whereas the Scottish Government have estimated the figure at closer to £0.8 billion. The size of the Scottish force and the relationship with existing UK forces would have some impact on procurement decisions that were made by the rest of the UK. Our estimate is that in the case of the simple removal of Trident, as opposed to the whole of the Faslane function, the job loss would be around 1,600 civilian jobs. In reality, the majority of those would be along the lines of security jobs rather than high-skilled jobs. That estimate includes the supply chain specifically for Trident. However, with the removal of the whole Faslane base, the estimate jumps to something like 11,000.

**Q666 Lord McFall of Alcluith:** I represented the area for many years. Would you agree that Dumbarton and Helensburgh would be decimated if those jobs went?

**Dave Moxham:** We produced a report, of which you may be aware, which visualised the removal simply of the Trident function and forecast a loss of 1,600 jobs. Obviously we were looking at that in a UK context. We viewed that as manageable as long as some of the intervention strategies that my colleague outlined were put in place. As you rightly point out, the regional impact of the removal of the whole base would be—well, “very significant” would be to understatement it.

**Q667 Lord Forsyth of Drumlean:** Do you think that an independent Scotland having a smaller tax base would put an effective limit on the size of our financial institutions?

**Stephen Boyd:** That is a very good question that relates to a number of other issues that have been discussed this morning. The size, structure and regulation of the financial industry is an issue that has been much discussed up to this point. There has been quite a lot of uninformed discussion about the implication of currency union, and whether it would be on a formal basis. A number of questions that flow from that will impact on the structure of finance in Scotland: for example, whether these institutions will still have access to the Bank of England as a lender of last resort that would be able to provide liquidity in the sort of scenario leading to the sort of hurricane scenario we faced in 2008. There are much bigger questions of prudential regulation and so on. We have not come close to answering those
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questions. If you are going to look at it in terms of an independent Scotland, with an industry structured roughly as it is at the moment, clearly the ability of the Government to undertake the bailouts of 2008-09 would be severely constrained.

Q668 Lord Forsyth of Drumlean: That is certainly the case. I am really thinking of an institution the size of the Royal Bank of Scotland, in an independent Scotland. It is hard to imagine why English taxpayers would want to be lenders of last resort to what had become a foreign country. In those circumstances the institution, whatever the arrangements with a Scottish central bank—which with dollarisation would not even exist—would find that the cost of raising capital and funds might be higher. Therefore, the temptation for a business might be to not register in Scotland but to move operations south of the border. Have you had any private conversations—I suppose that they would have to be private—with the senior management of financial institutions about what the implications might be for employment in those institutions? I have had private discussions, and what people say privately and what they say publicly are rather different. I wonder to what extent you are concerned, given that there are 200,000 jobs in financial services in Scotland.

Stephen Boyd: We have had discussions with representatives of the industry. I would not like to name individuals. I am not sure whether you will be speaking to Scottish Financial Enterprise. If you did, I am sure that they would have a list of questions about the nature of any currency arrangement with the UK, and about the terms on which an independent Scotland would join Europe. There are major issues there about whether to have a central bank. Industry is understandably concerned about uncertainty in these areas, and it is a concern to us, too.

Lord Forsyth of Drumlean: We heard yesterday from Scottish Financial Enterprise. I was a bit disappointed because their general line was that they wished not to take a position either way on the merits of independence, and that they would be asking the questions. The STUC has a long and distinguished history of taking a quite robust line on major policy issues. For example, you were very pro the establishment of a Scottish Parliament and devolution. Will you take a similarly robust line on the issue of whether Scotland should be independent?

Dave Moxham: That genuinely remains to be seen. There are very clear differences for us between this situation and our position, which you rightly articulated, in relation to the Scottish Parliament. Not to put too fine a point on it, there were two games in town: the status quo or the creation of a Scottish Parliament. A very large number of our members and of the overall Scottish population were clearly in favour of the latter: it was a bit of a no-brainer. This is a different situation. We calculate that, for obvious reasons, at least one-third of our members are pro-independence, and some still have to make up their minds. So while we may end up taking that position, we will come to it—dare I say?—with more caution than was necessary in the run-up to the creation of the Scottish Parliament.

Lord Forsyth of Drumlean: That was a very good, straight answer.

Stephen Boyd: Perhaps I can come back to the point about the financial sector. I think that the point you make that English taxpayers would not be prepared to support Scottish financial institutions through the lender of last resort facility of the Bank of England is very relevant. With a formal currency union with the UK, there could be some kind of fiscal pact, which again would constrain policy flexibility in an independent Scotland. Again, that is an issue much underdiscussed and underdebated. It is also important to throw into the mix that we are taking for granted that the structure of financial services will not change in an independent Scotland. From the STUC’s perspective, if Scotland was no longer to have,
under any constitutional scenario, a too big to fail financial institution, that would not necessarily be a bad thing. Clearly, what that means in terms of employment in the short or longer term remains to be seen. It is important to emphasise that we have a relatively large financial sector, but it has not always been to the benefit of the wider, productive Scottish economy. So if there is going to be structural change that might address that long-term problem, it might not be a bad thing.

**Q669 The Chairman:** I am very interested in your answers and would like to follow them up. First, on your point about the attitude that the STUC took to a Scottish Parliament, you mentioned the way one-third of your members were thinking. How were you polling your members on the issue of an independent Scotland, and will you be doing that in the run-up to the election?

**Dave Moxham:** We have yet to take a position. It would be a matter not for us but for our formally affiliated organisations. We are aware that a number of organisations, including some of our larger unions, are currently involved in polling and other forms of consultation with members. So undoubtedly we would expect them to come forward in larger numbers with individual majority positions one way or the other. You may be interested to know that we have two organisations that have stated with confidence the views of their members following consultations. The result comes out at one-all. The Fire Brigades Union has come out in favour of independence and ASLEF, the train drivers’ union, has come out against. It is interesting because both unions have a demographic that one would assume would be likely to favour independence: that is to say, they are men of a certain age. However, both of them have recent industrial histories that might have led their members to take one position rather than the other.

**Q670 The Chairman:** Mr Boyd, you mentioned some interesting points about the Bank of England being lender of last resort, and the possible consequent reactions of the British taxpayer. Obviously all of that would have to be negotiated in advance. Do you have a view on the currency issue? I think that you heard our discussion with the previous witnesses on the various alternatives in terms of currency. Do you have a view on which one you would prefer?

**Stephen Boyd:** I am afraid that I cannot give you a confirmed view at this moment. The consultation that my colleague described at the start of the discussion has flagged this up as a key issue, and it has been discussed before. There are pluses and minuses for all the scenarios. Clearly the Scottish Government’s preference is for a formal currency union with the UK. It is interesting that the First Minister seems to be moving towards a position where he does not believe that a constraining fiscal pact would necessarily have to be a part of that agreement. He pointed to the similarity in productivity and GDP per head between Scotland and the rest of the UK. Quite correctly, he flagged up the big divergences in productivity that were one factor in the euro crisis. We would struggle to see the circumstances in which UK Government politicians would be persuaded that the productivity argument trumps the argument that a fiscal pact is necessary. If a formal currency agreement is proceeded with, we think that there would be a fiscal pact that would constrain the First Minister.

**The Chairman:** So if sterling is the chosen currency after independence, you would recognise the importance of having a strong fiscal pact from the English taxpayers’ point of view, not least because of the complications of having the Bank of England as a lender of last resort?
Stephen Boyd: Yes. All the lessons that we have learnt in the last four years through the crisis would suggest that that arrangement would be necessary. The key point about such a pact would be the degree of flexibility that the arrangement afforded the Scottish Government. Again, to be fair to the First Minister, his point about productivity is well made. The agreement would have to have some flexibility, and it will be important for the Scottish Government to secure more flexibility than has been given to the Spains and Portugals of this world.

Q671 The Chairman: My question goes back to your polling—or getting the views of—your members. So far in this inquiry there has been pretty widespread recognition that the impact of a lot of key issues, which we are investigating as well, on the question that will come up at the referendum, is unclear. We have been discussing some just now. I assume that you take the view—as we do—that many more of these issues will have to be fully evidenced and made known to the public before a vote is taken, and indeed before your members express their view in any polling that you do.

Dave Moxham: That is exactly right. Without drawing too much on our own process, it has boiled down some key questions. I would rehearse them, except that they are very similar to the key questions about which you are asking us today. We will then look from our own organisation’s perspective to drill into those in significantly more detail and play a role, hopefully with others, in dissecting some of the issues in detail. It will be easier in some cases than in others. This will depend on what will be known pre-negotiation and what will be parked as a negotiating issue.

Q672 Lord Tugendhat: Would you expect an independent Scotland to introduce different rates of corporation and personal tax? The Edinburgh Parliament has had the opportunity to vary tax rates but has not done so. What would you see happening in the case of independence?

Stephen Boyd: Clearly the current SNP Government’s long-established policy is that one of the benefits of independence would be that they would have the policy flexibility for what they describe as very significant cuts in corporation tax, from which they think that we will derive benefits similar to those in Ireland over the past 20 years. We have always been extremely critical of that position. We think it rests on an erroneous analysis. Very important factors from the point of view of growth came together in Ireland in the 1990s. If we park the whole issue of the fiscal pact, which may well constrain the ability of an independent state to vary tax rates, the fiscal situation in the early days of an independent state is likely to be such that the ability to introduce previously described levels of corporation tax cuts will be very limited indeed. It is very difficult to see how that would generate the incentive effects that the Scottish Government think would lead to an increase in revenue. We think that it would lead, certainly in the short term, to a very significant increase in revenue. Under the kind of arrangements described for a formal currency union, it is difficult to see how taxation policy would diverge to a significant extent, although we would expect and wish that the tax system would include fairer allowances that would support innovation, the arts, communication, manufacturing, finance et cetera. There might be some interesting things you can do about that, but all within the context of not a huge degree of flexibility in rates.

Q673 Lord Forsyth of Drumlean: Perhaps I could ask a slightly tricky question. If we move to an independent Scotland, many of your members who at present are paid on nationally agreed terms and conditions—in practice this is what happens in the health service
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and elsewhere—would find themselves with their pay and conditions presumably up for renegotiation with the new Government. To what extent do you think that nationally agreed pay and conditions would survive the transition to an independent Scotland? If you think that they would change, would they go down or become more advantageous?

Dave Moxham: I am caught between wanting to advertise the massive strength of the trade union movement in Scotland and recognising the interconnectedness of the two economies, which I think would endure. The official position of course is that pay bargaining in areas such as the NHS is continued by arrangement. The UK level is already within the competence of the NHS and unions in Scotland to negotiate. I do not anticipate, certainly in this large bargaining area, an immediate divergence based on different economic situations or on the relative strengths of the trade union movement north and south of the border. We tend towards the position—perhaps this relates to the private sector organisations that have negotiated across the UK—that we prefer pay bargaining to take place on the largest scale possible. But I have no fears that in an independent Scotland, pay bargaining in some of these big public sector pay areas would be particularly detrimentally affected.

Q674 The Chairman: A final question then. You heard the exchanges we had with the previous witnesses about whether membership of the European Union would be seen as an essential—or certainly an important—element in the economic case for an independent Scotland, and whether they wished Scotland to remain a member of the European Union. They gave a unanimous yes answer. Is that the position of the STUC?

Stephen Boyd: It is at this moment in time. The degree of integration of the Scottish and European economies has already been described. That is extremely important, particularly at a time when we are all concerned about growth in the manufacturing export sector. The eurozone is a very significant export market.

The Chairman: You have heard the view expressed—this has been much debated in the media—that an independent Scotland would have to reapply for membership of the EU. You probably read in the Herald this morning what the Spanish Foreign Minister said about the time that it would take. Is this of concern to you?

Stephen Boyd: Yes, but it is a question that one has to approach with some humility. Our knowledge of international law and EU treaties is such that we cannot claim any degree of expertise on that question. The point was made in a previous session that this is fundamentally a political question that will be settled by politicians at a European level.

Q675 Lord Forsyth of Drumlean: I have just thought of a supplementary to my question about the role of the trade union movement in the UK as a whole. I think that it is fair to say that the Scottish trade union movement has played a pretty major part—greater than one would imagine given the size of Scotland relative to the rest of the United Kingdom—in the trade union movement and in its leadership. If there was an independent Scotland, that would obviously have a dramatic effect south of the border on the labour movement’s ability to win elections and so on. What do you think the effect would be on the strength of the trade union movement south of the border of secession and of the Scottish trade union movement becoming a separate organisation in a separate country?

Dave Moxham: I would like to suggest that it would become a hollowed-out shell, devoid of leadership—and I actually believe that it would have a significant impact. The first thing that would happen would be that unions individually would need to take a decision about how they structured themselves, and whether they would choose to structure themselves differently. Already we have a vast difference in terms of how centralised—for want of a
some unions are with respect to their branches north and south of the border. No doubt it would involve some reorganisation were that to be the case. However, were it to be the case that France had closer economic and labour environment conditions, we would look to extend and probably merge across borders rather than do the opposite. I would imagine that, backed by the fact that the STUC has always been the independent voice of the trade union movement in Scotland, unions would not be looking to atomise more than they needed to. The other part of your question related to electoral arithmetic. There are certainly concerns from some of our more active members down south that a United Kingdom shorn of what historically has been a majority of Labour MPs would make their electoral arithmetic more difficult. The reality of the situation is that 1974 was the last time that Scottish Labour MPs made the difference in the election of a majority Labour Government. However, it would be wrong to say that that is not a concern that is felt by our members down south.

**Lord Forsyth of Drumlean:** Your solidarity does you credit.

**Stephen Boyd:** I would just like to add a supplementary on issues around the labour market. It is probably worth highlighting that in the contribution to the debate over the past months, the failure of either side to address issues around the structure and evolution of the labour market has been quite startling. It has not been an issue at all up to now whether the labour market will continue in its present form. No one is addressing that and talking about the kind of things that might happen post-independence. For instance, an independent Scotland could move towards a more Scandinavian, more centralised and co-ordinated system, with collective bargaining in the private sector. We have heard from members of the yes campaign about major levers, but I stress that the fault is on both sides; the labour market has not been a focus of the campaign at all.

**The Chairman:** Before you made that comment, I was about to say in response to Mr Moxham that we deal entirely with economic issues, although we have been taken into areas that are not of immediate concern to the Committee. The point you raised is an interesting one and we shall certainly bear it in mind. I thank you very much indeed. This has been a very interesting and helpful session; we have covered a lot of issues and I am grateful to you for coming.
Standard Life and Scottish Financial Enterprise—Oral evidence (QQ 601-622)

Transcript to be found under Scottish Financial Enterprise and Standard Life—Oral evidence (QQ 601-622)
Thank you again for the opportunity to give evidence to the Economic Affairs Committee as part of its inquiry into The Economic Implications for the UK of Scottish Independence. In response to a question from Lord Forsyth (see p119 of the transcript) I undertook to provide a considered answer on the costs of regulatory compliance incurred by Standard Life as a UK financial services provider.

After a review of these activities we estimate our “business as usual” regulatory compliance costs for our UK business are in the region of £40 million per year.

I should make it clear this figure does not include regulatory compliance costs arising from our overseas operations, the cost of major ‘one off’ projects (e.g. Solvency 2, Pensions Reform and the Retail Distribution Review) or senior management time of which a considerable proportion is taken up with regulatory issues.

I very much look forward to the publication of the committee’s report. If I can be of any further assistance please do not hesitate to let me know.

15 January 2013
John Swinney MSP, Cabinet Secretary for Finance, Employment and Sustainable Growth, and Dr Gary Gillespie, Scottish Government Chief Economist

Q864 The Chairman: Good afternoon and welcome to the Economic Affairs Committee. This is the 19th and penultimate public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. We will be having one more public hearing next week before turning to consider our actual report. It is customary for us to have the ministerial witnesses towards the end of the public hearings and we are grateful to you, Mr Swinney, for coming, with your chief economist Dr Gillespie. Would you like to make a statement before we move into questions?

John Swinney MSP: If that is possible, Lord MacGregor, I would be delighted to do so. I begin by saying that I am delighted to be here this morning and I thank the Committee for its interest and the substantial ground that has already been covered in the inquiry. I hope to add to that today.

There are many reasons, Lord Chairman, why the Scottish Government believe that independence is the right way forward for Scotland, but let me focus specifically on two. First, devolution has allowed Scotland to act in some areas, such as health, education and
justice, in a way that suits Scottish circumstances and delivers results for Scotland whether through free education, care for the elderly or the action that we are seeking to take on alcohol pricing. We have, as it might be characterised, half the powers and I believe that, across the parties, we have used them well. We believe that this reinforces the principle that it is the people of Scotland who are the right people to make decisions about what happens in Scotland.

Secondly, it is particularly clear in my area of interest—finance and the economy—that the inability to pursue unique opportunities is restricting our potential and preventing us from delivering the best results for Scotland. Last week’s Autumn Statement created a very clear choice between continued austerity within the United Kingdom and unlocking the opportunities of independence. Scotland is in a stronger financial position than the United Kingdom. We contribute 9.6% of revenues with only 8.4% of the population. Whether we could be independent is now no longer disputed. What matters are the opportunities that independence would open up to invest in growth, to provide support to key industries and to tackle key social issues by connecting education, welfare, employment and the economy in a way that can only be done with the full levers of responsibility.

The Scottish Government have taken steps to ensure that this is an orderly process that gives the people of Scotland the opportunity to fully debate the issues and to cast their ballot in the referendum with confidence. We have concentrated on reaching agreement with the United Kingdom Government in a legally binding referendum. The Edinburgh agreement, signed in October, creates a clear and understandable process and commits both Governments to fully respect and implement the outcome. To ensure that voters can have confidence in the information that we give them on the financial arrangements, we established the Fiscal Commission Working Group, chaired by Crawford Beveridge and including the respected economists Professor Sir James Mirrlees, Joseph Stiglitz, Frances Ruane and Andrew Hughes Hallett. The group is advising on the macroeconomic framework and on securing economic growth and stability. I will be happy to send the Committee both its minutes to date and its initial recommendations, which are due in the new year.

At a wider level, the Deputy First Minister last week set out our intention to produce a series of papers that will establish the organisational structure of an independent Scotland and set out this Government’s view on why we believe that independence will be the right road for Scotland. As part of that process, we will discuss with organisations and stakeholders the route map that we propose for Scotland. As the Committee knows, yesterday we wrote to the European Commission following President Barroso’s recent remarks. I note that, while the President stressed that he was not speaking about a specific situation, it appears that he may have inadvertently created that impression. At a wider level, we are willing to engage in discussion and hope that the UK Government will participate and allow discussions at official level in line with the Edinburgh agreement to ensure that, in the event of a yes vote, both parties are ready to take forward the will of the public. The culmination of the information that we will put into the public domain will be our White Paper next autumn setting out our proposals clearly for the people of Scotland. That allows a substantial amount of time for the public to debate these issues and to form their view.

As part of this process, there is one final point, which is the process of transition. From a yes vote in 2014 through to independence in 2016, Scotland will remain part of the United Kingdom as we put in place the structure of an independent Scotland. That would be done through the Edinburgh agreement and, in particular, clause 30, which states: “The two governments are committed to continue to work together constructively in the light of the outcome, whatever it is, in the best interests of the people of Scotland and of the rest of the
United Kingdom.” Your Lordships are conducting an inquiry into the implications of Scottish independence for the UK. It is a decision for people across Scotland in 2014 whether to unlock the opportunities that I believe will come from independence and build our future based on the achievements of Scottish self-government to date.

Q865 The Chairman: Thank you for that. We will certainly in our questions focus very much on the second of your points, rather than the first. May I make two preliminary points? I think that it is important to emphasise that it is the custom of this Committee to base its report and conclusions very much on the evidence that we have heard—and we have certainly heard a lot of evidence. I must also make it clear that we are not considering the political and non-economic aspects of the referendum; we are considering solely the economic implications for both Scotland and the rest of the United Kingdom. The reason why we decided to do this was that we felt—I know that others feel the same—that there was a great lack of public debate about some of the absolutely critical issues, not only for Scotland but for the rest of the UK. We hope that both our hearings and our report will contribute to that whole process of listing all the major implications and some of the things that flow from them. I note your point about minutes and initial recommendations; it would certainly be helpful for us to have those.

Let me turn to the first issue. One of the key issues with major economic—I stress “economic”—implications is Scotland’s position in relation to the EU if there is a vote in favour of independence in the referendum. A number of our witnesses, particularly the business community, have stressed that to us. Previously, the Scottish Government has, as I understand it, maintained that Scotland would remain a part of the EU and that it had taken legal advice to this effect. When this Committee was in Scotland for our public hearings in late October, in both Edinburgh and Glasgow, that became a major issue in the Scottish media, because it became clear that the Scottish Government did not have such legal advice. That is why we decided to write to the President of the European Commission, seeking clarification of the matter. We received the reply from Mr Barroso yesterday afternoon. I think that it is important just to quote the key passages in that letter. One is: “If part of the territory of a Member State would cease to be part of that state because it were to become a new independent state, the Treaties would no longer apply to that territory. In other words, a new independent state would, by the fact of its independence, become a third country with respect to the EU and the Treaties would no longer apply on its territory.” He goes on to say that, according to the Treaty on European Union, such a country in this situation may apply to become a member of the EU: “If the application is accepted by the Council acting unanimously, an agreement is then negotiated between the applicant state and the Member States on the conditions of admission and the adjustments to the Treaties which such admission entails. This agreement is subject to ratification by all Member States and the applicant state.” In other words, there could be a veto. Can I ask you whether you agree that this is now the accurate statement of the position?

John Swinney MSP: What you have highlighted, Lord Chairman, in the first quote that you extracted from President Barroso’s letter is, I think, the nub of the issue—the quote that starts, “If part of the territory of a Member State would cease to be part of that state”, is the nub of the question. When I looked at President Barroso’s letter to the Committee, it struck me that when he is referring to the question of a country applying to be a member of the EU, he is very specific that that is under Article 49 of the Treaty on European Union. When President Barroso makes the remark he makes about a part of a country ceasing to be part of that territory, there is no treaty reference to that remark. I think that that is very significant. On my reading of the treaty position, I was struck on preparing for the
Committee when I reread some advice that was produced by the House of Commons Library about 12 months ago. They make the point in that document that there is no provision within the Treaty on European Union that provides for the scenario that President Barroso has cited in that particular paragraph of his letter. That really is why we think that it is very important that we have dialogue with the European Commission about this particular point. It has been an issue that we certainly think would benefit from direct discussion between the Commission and ourselves. Our circumstances give rise to the judgment that the course of action that we are proposing to take is an unprecedented case. It is not something for which the treaty has provided. Therefore, we need to have that dialogue. That was some detail to essentially say that I do not agree with the contents of President Barroso’s letter for the reason that I do not see the basis within the treaties on which that remark is founded.

Q866 The Chairman: But throughout our inquiry a number from the business community in particular, but there are others, have stressed—indeed, your own Government has stressed—the importance for Scotland of remaining within the EU or, as some of our witnesses have put it to us, being part of the EU and the single market. I would have thought that you must have been aware over the previous months that this is a pretty critical issue in terms of the economic implications for Scotland. Do you mean to say that you have not actually engaged at all in discussions with the European Commission on this matter?

John Swinney MSP: The first point that I would make, Lord Chairman, is that the Scottish Government accepts the importance for Scotland of continued membership of the European Union, for a whole variety of different reasons. You cited the interests of the business community and we accept that that is particularly important. That is why we have continued to assert the belief that we have that Scotland is a part of the European Union and we wish to remain part of the European Union after independence. In terms of dialogue with the Commission, the Scottish Government has taken forward what I would call informal dialogue with the Commission. The Commission have been very clear, for some considerable time, that they would only consider a particular scenario if that particular scenario was put to them by a member state Government. We certainly would be very happy to participate in dialogue with the Commission around the question of resolving this in response to a request from a member state for clarity from the Commission on this point. The very material point that I advance in that respect is the comment that I make about President Barroso’s comment not being founded on any part of the treaty. That therefore says to me that this—and this has long been a view that we have taken—is a process that essentially would ultimately become a process of political dialogue and discussion between relevant member states to be resolved as a consequence of a yes vote in the referendum. The very material point in this respect is that the referendum will take place in the autumn of 2014. We have always made it clear that there would have to be a process of negotiation and transition that followed that decision in principle by people in Scotland that they wished to proceed to independence. In that window between a decision on the referendum in the autumn of 2014 and the establishment of an independent country, which we believe would be possible through the elections to the Scottish Parliament in May 2016, there is the opportunity to essentially resolve that particular question.

Q867 The Chairman: But what is the opportunity? Is it to resolve the question as to whether an independent Scotland would have to make a new application, or do you mean the terms under which it would be made?
John Swinney MSP: I mean the terms of Scotland’s membership of the European Union. We are currently part of the European Union—today, that is our status through our membership of the United Kingdom. We would be making it very clear that we wished the continuity of that membership to be available for Scotland and, as a consequence of that, we would be negotiating the details around the terms of that membership, which would be the opportunity to resolve that question within the period between autumn 2014 and spring 2016.

Q868 The Chairman: It strikes me that it is a bit late to come up with this answer. It may have been thought about overnight in response to Mr Barroso’s letter. Have you got independent legal advice to justify your position or are you depending on a House of Commons Library note?

John Swinney MSP: There is a variety of expressions of legal opinion. There was one just the other day expressed by the Professor of Law at the University of Glasgow, Professor Tom Mullen, who made the point in a broadcast interview, which I am happy to provide to the Clerks. He said: “There is no specific provision in the treaty that expressly deals with the situation of a Member State breaking up and both parts wanting to stay in”. That confirms the view that I am taking. I cited the House of Commons Library paper, which says: “Nothing in the EU Treaties sets out what would happen in the event of part of a Member State becoming independent”. As you will know from your visit to Scotland at the time of the Committee’s hearings there—and we have now confirmed this with the consent of the Lord Advocate—the Lord Advocate’s opinion has been taken on this particular question. That of course will be available when the Lord Advocate has completed the formulation of that opinion.

The Chairman: So are you absolutely disagreeing with the fourth paragraph in Mr Barroso’s letter, which says: “If part of the territory of a Member State would cease to be part of that state because it were to become a new independent state, the Treaties would no longer apply to that territory”? Is that what you are disagreeing with?

John Swinney MSP: I am disagreeing with that point. That is the point that I think is the nub of this letter from the President of the European Commission. It is the issue where I think there is no foundation in treaty for that position to be supported.

Q869 The Chairman: So have you, in any informal discussions that you have had with the European Commission, made any reference to that? Have you taken that up at all? I assume that this letter has been extremely carefully considered and drafted.

John Swinney MSP: Well, its drafting by the European Commission is a really interesting point. It seemed to be available to the wider media in Scotland before it was available even to this Committee, from the press reports that I saw last week. Essentially, this reply was available to the Scotsman newspaper one day last week but it was not available to the Committee. I think that the drafting of the letter is a question of some interest to the wider debate.

The Chairman: That is not an answer to my question.

John Swinney MSP: What I am simply saying is that the point that is made here is a point for which I do not believe there is foundation in treaty. That is one of the issues that we want to discuss very clearly with the Commission.
The Chairman: It is a bit late to start discussing that. I am sure that this response will have created even more uncertainty in the business community.

John Swinney MSP: I do not think that it is late at all, Lord Chairman, because the Scottish Government, as I set out in my opening remarks, is going through a process which is about ensuring that the public are properly informed about the issues in connection with the referendum in good time for the referendum in the autumn of 2014. That will involve the production of a White Paper, which will be available to people in the autumn of 2013. That is the process that we are involved in; it is our timescale for making sure that the public are able to form that view. If I look back at the documents that the Scottish Government has provided and produced over time on this whole question, whether the original documents that we produced after our election in 2007 or subsequent reports that we have produced, we have made the point that there would have to be a negotiation about the terms of Scotland’s membership of the European Union and that that would be pursued with the European Union. We have always acknowledged the importance of a dialogue with the European Union on that question.

The Chairman: So in the studies that you referred to in your opening remarks, does this include a clear study of the views of the Scottish Government on the terms of entry that it might have to negotiate with the EU?

John Swinney MSP: Clearly, that will be the material substance of the discussions that we would take forward with the European Union. There will be a range of questions to be resolved about the terms of membership and a Scottish Government would willingly participate in those discussions.

Q870 Lord Lipsey: This really does seem rather bizarre. On the one hand, we have a considered letter from the President of the European Commission, who after all is the person who is going to decide, with the attendant legal structure, whether Scotland after independence, if it came about, was a member. On the other hand, we have the view of you as a Minister in a Government that has now admitted that it did not take legal advice on whether Scotland would remain a member of the Union and is only belatedly doing so. Yet you are saying to us, “No, no, we will still be able to go on being members. Don’t pay any attention to Mr Barroso’s advice”. Is that really a position that can be sustained for a single second?

John Swinney MSP: Yes, because the point which the Committee should be very interested in is the fact that there is no foundation in treaty for the comment that President Barroso has made in that letter. I cannot see where that comes from. The sources and comments that I have cited to the Committee are designed to help the Committee to share the view that I have. It is very interesting in the presentation of the letter that President Barroso, at the start of the second page, gives a very clear treaty reference to the terms of a country applying to become a member of the EU. At the top of the page, it says: “Under Article 49 of the Treaty on European Union, any European state which respects the principles set out in Article 2 of the Treaty on European Union may apply to become a member of the EU.” I completely accept that treaty reference and that comment, but my point is that, in the preceding paragraph, which is—and I agree with you, Lord Chairman—a very significant paragraph, there is no treaty reference. The reason why there is no treaty reference is that there cannot be any treaty reference because such provisions do not exist in treaty.

Q871 Lord Lipsey: There is a reference to the treaties; it says that they only apply to member states. So it is not relevant whether there is a treaty reference. Of course there is
not, because you are not then a member state. I do not understand why you do not take the following line: “Yes, we accept what Dr Barroso said. Of course we wish to apply for membership of the European Community and I am sure that it will be solved politically”. That seems a perfectly sensible, straightforward and defensible position. To retreat into clearly implausible references to what is referred to in the treaty, to which you would no longer be signatories because you would no longer be part of the EU, seems to me to be the last refuge of a scoundrel, if I may say so.

**John Swinney MSP:** What that misses, Lord Lipsey, is the point that as Scotland is taking this particular course in the aftermath of a referendum in the autumn of 2014, Scotland remains part of the European Union because we would still be part of the United Kingdom; we would not have enacted the Act of independence. Therefore, in that period after a referendum and before the establishment of an independent state in the spring of 2016, Scotland would be involved in a process of settling the independence process and conducting negotiations with the United Kingdom Government and with the European Union about the terms of Scotland’s membership of the European Union. In that context, I think that it is an entirely appropriate way for us to proceed with the discussions that we must take forward.

**Q872 The Chairman:** If that process were unsatisfactory from your point of view, would you withdraw a desire for independence?

**John Swinney MSP:** The people of Scotland will have decided in the autumn of 2014 whether or not Scotland is going to be an independent country; that decision will have been taken by the people in a referendum. What it is up to the political leaders of Scotland to do is to give effect to the decision that the people of Scotland have taken.

**The Chairman:** Even if the terms are very unsatisfactory for Scotland?

**John Swinney MSP:** Our duty is to take forward the question of independence and to ensure that we deliver a strong settlement for the people of Scotland, which I would be confident we could do given the strength of Scotland’s participation in the European Union, given the significance of the contribution that we make, given the significance of the interest that we have—not just for us, but for other member states that are tied up with their participation and their work with Scotland across a whole variety of industrial and business sectors.

**Q873 Lord Forsyth of Drumlean:** Your line appears to be that President Barroso does not know what he is talking about on this matter, and that he is wrong when he says that if Scotland leaves the UK it also leaves the EU. If the vote is going to take place in 2014, how do you intend to establish before 2014 exactly what the position is? Are you going to take a legal challenge to the Commission? How will you establish what the facts are, so that people when they cast their vote know what the position will be?

**John Swinney MSP:** Essentially, Lord Forsyth, the approach that we would be taking is the one which the Deputy First Minister set out yesterday, which is to embark on dialogue with the European Commission on this particular question, and to ensure that that dialogue gives the European Union a clear understanding of the perspective that we are bringing to that process and enables us to discuss with the European Union the most effective approach we can take to provide maximum clarity.

**Lord Forsyth of Drumlean:** So you are hoping to change his mind.

**John Swinney MSP:** Yes. Certainly in terms of that paragraph in his letter, yes.
Lord Forsyth of Drumlean: So if you are not successful in changing his mind, presumably you will continue to challenge it. My question really is because—wearing your economics hat now—we have had a lot of evidence from businesspeople and others, and one of the things that people stress is the thing that business absolutely loathes, which is the uncertainty. How are you going to cope with the economic impact of the uncertainty, because we have to wait two years for the referendum, and you have described a two-year period after the referendum of negotiation? That is four years where people, perhaps in farming or fishing or inward investors, do not know what the position will be about our membership of the European Union, what the terms will be, what the currency will be and the rest. How damaging do you think that will be to the Scottish economy, or do you think it is beneficial? What assessment have you made of the impact on investment and the economic climate in Scotland arising from the uncertainty created by this whole business of having a referendum without having clarity on issues like membership of the EU?

John Swinney MSP: I accept the importance that Lord Forsyth attaches to the desire from the business community for certainty; I hear that from the business community all the time about everything, and I am sure that Members of the Committee will hear that from the business community about all manner of questions on a regular basis. The pursuit of certainty is important to me, because it clearly affects economic performance. If I can look at the performance to date, one of the best examples of the performance on inward investment is the analysis carried out on an annual basis by Ernst & Young of the relative investment attractiveness of different parts of the United Kingdom. For two years in succession, Scotland, while all this debate has been raging—

Lord Forsyth of Drumlean: That assumes that Scotland is in the EU. I am asking about the uncertainty created by this policy.

John Swinney MSP: Your point to me, Lord Forsyth, was about the period from now to taking forward this argument, and I am simply saying to you that, in the current environment, when there is intense debate on this subject, Scotland is performing at the highest level of any part of the United Kingdom in terms of investment attractiveness, despite the constitutional debate going on. That is an indication that we are able to navigate a course in terms of supporting and steering the Scottish economy that is beneficial to the interests of the business community.

Lord Forsyth of Drumlean: But while this has been going on you have been telling them that you had legal advice that Scotland would remain within the EU.

John Swinney MSP: What we have been doing is we have been setting out the legal debate which exists. I have gone through the detail of that, about the fact that we think that an independent Scotland would assume the obligations of the United Kingdom—that it would continue in its membership of the European Union—and that remains our position. I disagree with President Barroso’s position, so I have no reason to set out a different or alternative proposition in that respect.

Let me make one other point about uncertainty. On the European question, the degree of uncertainty that surrounds the United Kingdom’s continued participation in the European Union will be of enormous concern to members of the business community in a whole host of different ways. If I read the runes correctly, it looks to me as if there is some prospect being offered—perhaps a tantalising prospect for some—of a referendum on the United Kingdom’s continued participation in the European Union. We can all see from that that there is the potential for there to be uncertainty. We operate in a world where, yes, there are big questions that have to be answered, and we are working to address those big
questions, but what is also important is that we keep a sense of perspective about our ability to deliver investment performance when this debate is actually taking Scottish—

**Q874 Lord Forsyth of Drumlean:** One quick additional point if I may: you talked about the position of Scotland leaving the United Kingdom as a member state as unprecedented. On the issue of precedence, what do you think of the view that has been expressed by the Spanish Foreign Minister and others who are concerned about the precedent that would be created if part of a member state was able to leave the European Union, and the implications for places like Catalonia and elsewhere?

**John Swinney MSP:** I suspect the best thing for me to do, Lord Forsyth, would be to quote the Spanish Foreign Minister himself. He was quoted on 24 February this year with these words: “If in the UK both parties agree that this is consistent with their constitutional order, written or unwritten, Spain would have nothing to say, just that this does not affect us. No one would object to a consented independence of Scotland”. The really significant thing which has entrenched that process since Señor García-Margallo made that remark in February is the signing of the Edinburgh agreement, because the Edinburgh agreement, to me, is a very clear statement of the desire of both the Scottish and the United Kingdom Governments to address this issue. I quite accept the United Kingdom Government’s position that they would prefer that there was not to be a referendum on independence—that has been clearly stated by the United Kingdom Government—but they have come to an agreement with us. The key point of that agreement—there is a lot of order put in place around about the agreement—with which it concludes are the words: “The two governments are committed to continue to work together constructively in the light of the outcome, whatever it is, in the best interests of the people of Scotland and of the rest of the United Kingdom”. So what we have is a consented process around the referendum—that this is the process we will follow—and a consented process to work together constructively in the light of the outcome. I think that helps things enormously because, to go back to the comment of the Spanish Foreign Minister, it was, “No one would object to a consented independence of Scotland”. Those are the remarks of the Spanish Foreign Minister.

**The Chairman:** I have three other colleagues who want to come in on this issue, and then we will move on to other issues.

**Q875 Lord Shipley:** I wonder if I could ask you to be really precise about what it is that you think the people of Scotland should know about EU membership before they vote in the referendum. You said that the public should be properly informed about the issues before the referendum, so what is it in terms of EU membership that must have been agreed so that the public understand what they are voting about, and what is it that can be left until after a referendum campaign for the negotiation that follows, to use your words?

**John Swinney MSP:** The process of decision-making by the people of Scotland would be enhanced if as much information and definition as possible about the terms of Scottish membership of the European Union were available in advance of the referendum, which is why I have set out to the Committee in my opening remarks the fact that we have written to the European Commission asking for that dialogue to take place, and why also I set out our aspiration that officials of the Scottish Government and officials of the United Kingdom Government should work together to develop some of the groundwork around about these questions. If I look carefully at some of the transcripts of the Committee’s evidence from other players in this discussion, I think the Members of the Committee have been arguing for there to be what I might call some preparatory dialogue about some of the issues in advance
of the referendum in 2014. I can quite understand why the Committee has come to that conclusion. In answer to Lord Shipley’s point, it would be beneficial to give as much clarity as people could have in deciding on how to vote in a referendum.

Lord Shipley: But as a minimum, presumably people who are going to cast a vote in a referendum campaign would need to understand whether they would have to reapply for membership of the European Union or not. Is that your position? It seems to me that that would be a critical issue which, if I were voting north of the border, I would want to understand.

John Swinney MSP: Clearly, it would be advantageous for as much ground to be covered in the process in advance of a referendum as is possible. I cannot give a view on behalf of the European Commission or a range of member states as to what conclusions they would arrive at, but I think the greatest amount of clarity we could have before the referendum would be beneficial.

Q876 Lord Skidelsky: Let me just try to sharpen your reply here, though I suspect I am not going to succeed. Will the Scottish Government put clearly to the Scottish electorate that there is a strong possibility that an independent Scotland would have to reapply for membership of the European Union, and that there may be a period before the application process is completed when an independent Scotland would not in fact be a member of the European Union—just a strong possibility? Will that be put clearly so that when people vote they actually understand the gamble they are taking on continued membership of the European Union?

John Swinney MSP: To give you a sharp answer, Lord Skidelsky, no, we will not do that because we do not take that view. For the question of there being a period where Scotland might not be in the European Union, the issue that has to be recognised—it is at the heart of the comments I have made about the paragraph that the Lord Chairman highlighted to begin with—is that there is no mechanism to disapply the treaties from Scotland. There is no such mechanism; therefore we could not put to the people of Scotland a comment that somehow the treaties would disapply because there is no provision within the treaty to enable that to happen.

Lord Skidelsky: Yes. Just one supplementary: that ignores the view of Mr Barroso, which is presumably a view of the Commission, that there would be a new legal situation on independence. That at least creates a possibility.

John Swinney MSP: The Commission has to operate within its legal framework. EU law is a body of law within which member states and the Commission must operate, and I simply put it to the Committee that I cannot see the foundation in treaty which enables President Barroso to make the remark that he has made there.

Q877 Lord Hollick: I really want to follow up on the same point. You said two things which struck me. One was that you want the electorate to cast their vote with confidence. To cast a vote with confidence, I take to mean that they have the relevant facts on the position or major issues in front of them. You then went on to say that the process for resolving the question or issue that has arisen out of this letter from Mr Barroso will take place in the period 2014-16—in other words, after the referendum has taken place. I infer from that, which you acknowledge, that it may not be possible, and indeed it is likely, that the issue of membership, the process of application and, of course, critically, the key terms of that membership will be unknown at the time of the referendum. If that is the case, would...
you still regard the electorate in Scotland to be in a position where they could cast their vote with confidence?

**John Swinney MSP:** The point that I make, Lord Hollick, is that that is why we made the approach that we did to the European Commission yesterday. The issue can be resolved in advance of 2014, given the relevant dialogue between the parties to enable that to happen. What is important here is that we construct a proposition based on fact and evidence to members of the public. There will be some questions that, inevitably, cannot be resolved with absolute definition—I would have to accept that that would be the case—but there is the mechanism, because there is such a lack of foundation in the treaty on the point that I have been making today about President Barroso’s letter, that would enable that to be resolved by dialogue with the Commission.

**Q878 The Chairman:** But if it were not by 2014 and if Mr Barroso’s position as stated in this letter still stands in relation to no longer being a member of the EU, what effect would that have on your position in the referendum?

**John Swinney MSP:** You are inviting me to speculate on a hypothetical situation, Lord MacGregor, and I would not want to do that, because the intention of the Government is to try to provide as much clarity as possible to people in Scotland, and that will be the focus of the approach that we take to the European Commission and in our dialogue with the United Kingdom Government.

**The Chairman:** I must say that, given that throughout our hearings this issue of certainty, particularly in relation to the position of an independent Scotland in the EU, has featured in so much of the evidence that we have been given, I find it slightly surprising that you come up with this request of “Go and have a discussion with the EU” at this late stage. I would have thought that you would have done that earlier. I think that we have to assume that the position that Mr Barroso has outlined is very clear.

**John Swinney MSP:** The issue that I would make to you, Lord Chairman, is the fact that the European Commission has been saying for some time that it would only ever comment on a specific scenario if requested to do so by a member state. The United Kingdom Government have made it clear that they would not be prepared to do so. President Barroso has been at pains to stress throughout his media interviews on this question—he also makes the point in his letter, saying, “While refraining from comment on possible future scenarios”—that, without commenting on a specific scenario, he is making a general observation. In his general remarks, he may have inadvertently created a bit of specificity about it, but the European Commission’s position has been that it would provide clarity in response to a request from a member state. The whole process can be advanced through the dialogue that we have set out as being important with the Commission.

**The Chairman:** Well, we must now move on to a lot of other issues, so we will start with Lord Levene.

**Q879 Lord Levene of Portsoken:** Mr Swinney, good afternoon. Last week we had evidence from Lord West, the former First Sea Lord, who said that he believed that Scotland could lose more than 10,000 jobs in the defence area if it became independent. If that were to come about, how would you propose that an independent Scottish Government could make up that loss of employment?

**John Swinney MSP:** I saw some media reports of Lord West’s remarks, Lord Levene; I am not sure of the basis of the detail that underpinned the assessments that he was making. I
would make two points in this respect. The first is that it is really important that we do not suddenly think that Scottish independence is the only scenario in which it is possible to lose defence employment. Between 2000 and 2011, the number of MoD civilian service personnel decreased by just over 14% in the United Kingdom. They decreased by over 28% in Scotland, so double the number of defence jobs that were lost in the United Kingdom were lost in Scotland under the constitutional arrangements. My first point is that we have to be very careful in not assuming that somehow only independence creates the potential for there to be any change in the defence workforce. The second point I would make is that there is a real disparity between the spending profile on defence and the assessment made of the actual defence footprint within Scotland. We publish on an annual basis a document called *Government Expenditure and Revenue Scotland*. On topics such as this, it is designed to identify how much money Scotland puts into the United Kingdom and how much money is spent in turn. It makes an assumption that we contribute, based on our population share, £3.3 billion towards the defence and security of the United Kingdom. When you look at what is spent in Scotland in terms of our defence footprint, the figure is, on average, at least £700 million lower than that figure of £3.3 billion. As a consequence of independence, there is clearly a requirement for us to provide effective military support within the country. The mismatch between those two statistics that I have given you indicates that Scotland is currently contributing more to the combined defence of the United Kingdom than we are receiving in return in terms of defence footprint within Scotland.

**Lord Levene of Portsoken:** That was not really my question. If Scotland were to lose a lot of defence jobs—as you say, you lose them anyway—how do you propose to make up the deficit?

**John Swinney MSP:** If I can answer the question in relation to any negative economic impact on the economy, I am wrestling just now with a couple of major plant closures in Scotland. We are losing the best part of over 2,000 jobs in the food processing sector. The Government are working to retrain those individuals who are affected. We are developing as part of our wider economic strategy investments in new industries, whether that is in renewables, the development of life sciences activity or whatever the sectors happen to be. We see an active role for government in taking forward such an approach to ensure that, where there is a negative economic impact on the country, we can take steps to remedy it. If there was to be a situation in the defence sector or in the financial services sector or in the food and drinks sector, the Scottish Government would take the same approach.

**Lord Levene of Portsoken:** So you are saying that, if there were a shortfall in jobs in defence and if, for example, in the event of independence, the rest of the UK stopped placing warship orders in Scotland, which has been a historically significant source of work, then you would just go and look for something else in a different industry.

**John Swinney MSP:** In as specific an example as that, we would want to act to support and enhance the performance of the shipbuilding sector. The reason Scottish yards construct ships is not an act of charity by the UK Government; it is because they are good at doing so. I would be confident that they would remain good at doing so after independence and be able to take forward the relevant opportunities in that respect.

**Q880 Lord Levene of Portsoken:** That may well be the case, but for the work that is placed, there is always a tremendous amount of competition from different parts of the United Kingdom and different companies. Clearly, if the United Kingdom Government want to put the work in businesses in their own territory, they will do so. If there is the
opportunity then to place the work in a Scotland which is then an independent country, it will be less attractive to them.

**John Swinney MSP**: What I would hinge my answer in that respect on is the fact that Scottish yards deliver excellent-quality propositions. Clearly, any defence orders would be based on the principle of quality of proposition. If you look at the marketplace now in defence orders, you see an increasing pattern of defence procurement being undertaken cross-border. There are numerous examples of that now taking their course. I would be confident that the strength and the capability of Scottish yards would be able to operate in that context.

**Lord Levene of Portsoken**: Are there any instances of shipbuilding orders for the Royal Navy being placed outside the United Kingdom?

**John Swinney MSP**: There has been an example of a case in South Korea where the MoD has named Daewoo as the preferred bidder on a £452 million contract for refuelling tankers for the Royal Navy fleet.

**Q881 Lord Levene of Portsoken**: I was talking about warships. Anyway, I shall not press the point. On a different issue on defence, are the Scottish Government committed to retaining the historic Scottish regiments after independence? Lord West, when he spoke to us last week, said that he doubted that that would be possible, not least because many might opt to remain within the better resourced forces of the rest of the UK. Clearly, the question of the Scottish regiments is fairly emotive, both in this country and in Scotland.

**John Swinney MSP**: There has been a clear importance and tradition attached to the character and identity of the Scottish regiments. That has been significantly eroded over the last number of years. We think that the re is an operating basis within which a Scottish army could ensure that those regiments were able to have their identity preserved. We would of course have to have an army; that would be a requirement of fulfilling our conventional defence obligations to the country. That would give us the opportunity to ensure that that historical tradition was maintained.

**Q882 The Chairman**: Could I just say on defence that I quite understand that you have not been able to see what Lord West said to us last week, but the transcript will be available very soon. It was a very lengthy session based on his experience and expertise over many years, particularly in the Navy but in defence generally. He makes a number of comments about the implications for Scotland’s own defence and, if it were possible for you to give us any written replies to some of the points that he makes, that would be very helpful.

**John Swinney MSP**: Certainly. As you correctly say, Lord Chairman, I have not been able to see the transcript in full, but I shall certainly reflect on that and provide some comments.

**The Chairman**: Thank you.

**Q883 Lord Smith of Clifton**: Mr Swinney, if we can talk about monetary union and arrangements in general, you stated in your David Hume Institute lecture in February that monetary and fiscal measures are prominent instruments of economic policy. You have since suggested that if Scotland becomes independent, the preferred monetary framework would be a sterling currency zone between some or all of the nations of the United Kingdom. Can you please tell us more about how this currency zone would work?

**John Swinney MSP**: I can. The core proposition is for us to establish a formal monetary union with the rest of the United Kingdom with the Bank of England operating as the central
bank for sterling and so on, discharging its functions on behalf of both fiscal authorities in Scotland and the rest of the United Kingdom. Those functions would be on essentially price stability and financial stability. We have set out that strategic detail of the approach that we plan to take and we have asked the Fiscal Commission Working Group, to which I referred in my opening remarks, led by Crawford Beveridge, who is the chair of the First Minister’s Council of Economic Advisers, and including a number of eminent economists and Nobel laureates, essentially to assess and consider that detail. Of course, there will be a publication, as I indicated in my earlier remarks, from the Fiscal Commission in the spring. That will be available to the Committee, but, in advance of that and to assist the Committee in formulating its conclusions, I will happily make available what papers I can to that process.

Lord Smith of Clifton: Quite how do you engage with London and the Bank of England in your eminent persons’ committee to come up with some sort of arrangement? Would it be that the Scottish Government had a representative on the Bank of England?

John Swinney MSP: I have seen the inquiries that the Chairman has made of the Bank of England in relation to dialogue with us on this question. We have had dialogue with the Bank of England on the arrangements that we have put forward. That has been a very helpful dialogue. Essentially, what that will help to do is inform the model that we bring forward to ensure that the issues and points raised with us by the Bank of England can be properly reflected by the Fiscal Commission Working Group. That will be available once that report is published. This forms an essential part of the framework for monetary policy that we would take forward and it would be designed essentially to reflect the shared interest that Scotland and the rest of the United Kingdom would have in price stability and financial stability.

Q884 Lord Hollick: With the financial and banking crisis of 2007 and 2008 very much in mind, could we just explore the issue of the lender of last resort? If an independent Scotland retained sterling, there is some sort of relationship that I think you are anticipating you could have with the Bank of England. Would that extend to the Bank of England being the lender of last resort so that, in extremis, there would be a substantial institution that could stand behind the Scottish financial institutions if there were to be another crisis? Could you explain why the Bank of England would want to play that role and what incentive there would be for it to do so for an independent country?

John Swinney MSP: The foundation of the answer to this question comes back to the current role of the Bank of England. It may be called the Bank of England, but it is, as the Governor said to the Committee earlier this year, the bank of the whole of the United Kingdom. I suppose that it is as much our bank as it is anybody else’s bank, in that sense, so it performs that function currently. We would wish the Bank of England to continue to provide that role in terms of lender of last resort to financial institutions. Why would that be of interest to the Bank? It would be of interest to the Bank because, obviously, the Scottish economy would be contributing to the sterling zone, in terms of our economic and industrial capacity and capability. Our trade would be contributing to the sterling zone, so all these factors would be essential components of the strength of the sterling zone, and the Bank of England would have a strong and immediate interest its health and welfare.

Lord Hollick: But what you describe could be applied equally to the eurozone, which is struggling to address these very issues now, because there is no central bank of last resort. In fact, some of the latest discussions on the European banking union suggest that each country would be responsible for its own lender of last resort to its own financial institutions.
Against that background, I cannot see why the Bank of England would want to put its resources behind another country, a completely independent country, notwithstanding the fact that it was using the same currency.

**John Swinney MSP:** I think some of the answer lies in the discussion that is currently going on, certainly within the eurozone but also between regulators in the United Kingdom and the United States, about essentially recognising the fact that institutions are operating across jurisdictions and in a multiplicity of jurisdictions. There has to be a collaborative understanding of how the issues of potential financial instability can be addressed as a consequence. The model that we are talking about emerges from the same stable of thinking that is, for example, leading to the dialogue between the Bank of England and the Federal Deposit Insurance Corporation in the United States about how some of these issues are addressed across borders. I think that the thinking in that respect recognises the fact that these institutions are trading very much across borders.

**Lord Hollick:** Those discussions seem to me to be very much about the subsidiaries of British or American banks that are in the other countries rather than about bailing out the whole banking system, which is what the lender of last resort would have to do in the circumstances that you are anticipating. At the very least, what you have identified is a very significant issue which could be resolved only after the referendum has taken place. It is an issue which, if it were not resolved satisfactorily, would lead the financial institutions in Scotland into a rather difficult, possibly precarious, position and would therefore affect their ability to access international capital markets.

**John Swinney MSP:** Let us look at some of the approaches that have been taken, for example, on obtaining liquidity for financial institutions. The Federal Reserve, for example, I notice had made available about £85 billion-worth of liquidity support to the Royal Bank of Scotland in the midst of the crisis. The understanding and the acceptance of the different roles of different institutions in supporting the financial system are reflected in that experience.

**Q885 The Chairman:** But at the very least, and a lot of our evidence has pointed that way, there would have to be very strong agreements about a fiscal pact between the rest of the United Kingdom and the Scottish Government in order to protect the position of lender of last resort.

**John Swinney MSP:** You are preaching to the converted on fiscal responsibility, because my core duty in the Scottish Government is to make sure that we manage our resources properly and effectively and that we take fiscally responsible decisions. For the last five and a half years, I have balanced government budgets. I have not borrowed, I don’t have the ability to borrow, so I have had to live within resources. I am a believer in effective fiscal frameworks to guarantee that we have fiscal responsibility in the public finances. If only there had been a little bit more of it in other places.

**The Chairman:** Well, one cannot depend on one prudent Finance Minister for all time.

**John Swinney MSP:** It is not the point I am making; the point that I am making is that importance has to be attached to frameworks of fiscal responsibility. The point is that if the United Kingdom Government had perhaps observed a bit more tightly the framework of fiscal responsibility that they had created for themselves, we may not have ended up in the mess that we did.
The Chairman: Many of us would agree with that, but it is not really the question for the future. We are also getting a lot of evidence about the volatility of the revenue from North Sea oil, so there is an issue there, too. It would seem to me essential that, if the Bank of England was to act as lender of last resort, there would have to be a strong fiscal pact that would be binding on a future Scottish Government.

John Swinney MSP: On the question of volatility of oil and the dependence that Scotland would have on oil revenues, I was quite interested in the comparison with Norway. Fifteen per cent of tax revenues in Scotland are accounted for from oil and gas; in Norway, it is 26.4%. There is very strong emphasis on and evidence of fiscal stability in the Norwegian financial system which we should learn some lessons from.

Q886 Lord Forsyth of Drumlean: Of course, but Norway has an oil fund and is not using it to fund current expenditure. Can we just get back to Lord Hollick’s point about lender of last resort? I genuinely do not understand the argument. The Lord Chairman has pointed out that, if the Bank of England was going to be lender of last resort, there would have to be in place a fiscal pact—that would a sine qua non—which would limit the freedom of the Scottish Government in respect of what they could do. Why would the Bank of England—which was actually founded by a Scot, William Paterson, who then went on to promote the Darien scheme which led to the bankruptcy of Scotland and in turn to the union, ironically enough—want to stand as guarantor to what would become a foreign country, Scotland, when the only money that it has is provided by taxpayers?

John Swinney MSP: It would be the guarantor to financial institutions in Scotland.

Lord Forsyth of Drumlean: But why?

John Swinney MSP: Well, because it would have an inherent interest in supporting the sterling zone that would be created, because both countries would be using the same currency. The Bank of England’s inherent interest is ensuring that it provides effective price stability and financial stability. If the two countries were utilising the same currency, it would be in the inherent interest of the Bank of England to fulfil that purpose.

Lord Forsyth of Drumlean: But surely it could only do that—unless you were going to go in for some dollarisation—if it had absolute control over the way in which Scotland was borrowing and performed its economic activity.

John Swinney MSP: Not “control over”, Lord Forsyth; perhaps confidence in. That is a fundamentally different proposition because it relates to the actions and decision-making of government in relation to the financial priorities that we set.

Lord Forsyth of Drumlean: So your proposition is that, if we had had an independent Scotland and the Bank of Scotland and the Royal Bank of Scotland had got into the difficulties that they did, the English taxpayer would quite happily have coughed up and that such an arrangement would be sustainable.

John Swinney MSP: The problem with that analysis is that it rather ignores that the Royal Bank of Scotland and the Bank of Scotland did not get into a financial mess just because of the transactions being undertaken within Scotland; it was because of the transactions being undertaken across a much wider jurisdiction.

Lord Forsyth of Drumlean: I am not asking why it got into a mess, but its jurisdiction would have been in Scotland.
**John Swinney MSP** My point is, and the reason why I answered the question in the way that I did, Lord Forsyth, is that the issues of financial difficulty that the Bank of Scotland and the Royal Bank of Scotland got involved in were the product not just of Scotland but of the entire operations, some of which would have been taking place in England and Wales and some in other parts of the globe. The key issue here is recognising that there is a shared interest in guaranteeing the financial stability of these institutions.

**Q887 Lord Lipsey:** Let us just go back to the eurozone, which Lord Hollick raised. At one stage, I think that it was SNP policy to join the euro. One quite understands why that policy is now different, but would you want to rule out for ever joining the euro as an independent Scotland?

**John Swinney MSP:** Lots of parties have been in favour of joining the euro in the past and are no longer in favour of it.

**Lord Lipsey:** Indeed

**John Swinney MSP:** Certainly, I cannot foresee circumstances in which an independent Scotland would want to join the euro.

**Lord Lipsey:** Does that not give you a difficulty if the Barroso view prevails—namely, that you have to apply to join the EU? I believe that all applicants to the EU now have to say that they will join the euro when they can.

**John Swinney MSP:** There are two particular points that are relevant there. The first is that, for a country to join the euro, it has voluntarily to join the exchange rate mechanism. Clearly, we are not in that and would not voluntarily join it. If you then go into treaty obligations, you see that Sweden has a treaty obligation to join the euro but has made it absolutely clear that it is not doing it.

**Q888 Lord McFall of Alcluith:** Mr Swinney, you suggested in your speech in June at Glasgow Caledonian University that having the Bank of England in charge of regulating UK financial services was “a very sensible and long overdue position and retaining the pound will preserve the highly-integrated UK financial services market”. Are you suggesting that the Bank of England should regulate Scottish financial institutions even as an independent nation?

**John Swinney MSP:** Only in respect of the requirements for financial stability in relation to the banks.

**Lord McFall of Alcluith:** Would you have two regulators, then?

**John Swinney MSP:** We would have to have for the purposes of macroprudential regulation a regulatory environment, which is the point that I have just made to Lord McFall in relation to the banks. There would also be a requirement for micro-regulation in relation to the operations of financial services companies. Clearly, we would have to fulfil our obligations in that respect. We are anxious to ensure that that function is taken forward in a fashion that is as conducive as it possibly can be to the operational activities of the relevant financial institutions.

**Lord McFall of Alcluith:** So two issues could come up here: regulatory arbitrage—if you have two regulators—and capital possibly moving across borders, which could be highly destabilising. How would you prevent that?
John Swinney MSP—Oral evidence (QQ 864-900)

*John Swinney MSP:* The role of the Bank of England in relation to the requirements of macroprudential regulation for the purposes of financial stability would deal with the point of capital transfer across borders.

*Lord McFall of Alcluith:* So the Bank of England would rule on that.

*John Swinney MSP:* That would be its role. Then, in relation to regulatory arbitrage, if I look at the emergence of the environment for regulatory oversight across the EU in this area, I see an increasing tendency for much of this activity to be undertaken on a European level, or to be designed at a European level. Of course, we would have to accept our obligation to fulfil our commitments in that respect.

*Lord McFall of Alcluith:* Following on from that, you are suggesting then that the Bank of England would deal with any problem of moral hazard, where lax regulatory oversight in Scotland could end up with the UK footing the bill. Would it be in charge of that concept?

*John Swinney MSP:* I have set out what the role would be in relation to the macroprudential regulation, which I think addresses the point.

*Q889 Lord McFall of Alcluith:* Okay. Just a last point on the EU. I think that you said that President Barroso or the Commission would respond regarding clarity only to a member state. Scotland will not be a member state up until 2016, so is it the case then, following your logic, that there will be no clarity till after the vote?

*John Swinney MSP:* As Lord McFall correctly says, Scotland is not a member state in its own right at this moment, so the invitation essentially is there to the United Kingdom Government to pursue this issue. We think that it is important that we have dialogue with the Commission to encourage some progress on that question, because there is quite clearly in our view a fundamental difference of opinion in relation to the contents of that advice.

*Lord McFall of Alcluith:* So you want the United Kingdom Government to negotiate with President Barroso to give you that answer.

*John Swinney MSP:* If I follow the evidence and the line of questioning that the Committee has taken with a number of witnesses over the length of this inquiry, it looked to me reading it on paper—I do not want to put words into the mouths of the Committee—particularly in the session that you had with the Chief Secretary to the Treasury, that the Committee was pretty much saying to the UK Government, “There is a bit more you could be doing here to establish clarity”. I am all in favour of dispassionate clarity.

*Q890 Lord Hollick:* It does seem to me, around this issue of the Bank of England, that there is quite a lot of wishful thinking. It is sort of, “Make me independent, but not just yet”. In other words, “I would like to have the benefit of a central bank, a regulator and a lender of last resort looking after me. I am a little bit nervous about having complete fiscal unity, because that compromises my independence”. Is this really a step towards full independence? How do you see this developing over time?
John Swinney MSP: What I am saying to the Committee is that this is the proposition that the Government will put to the people of Scotland in the referendum in 2014. That is essentially the proposition to judge upon.

Lord Hollick: The British Government—the UK Government, the Government in London—could say, “Well, forget that. We are not going to do it”.

John Swinney MSP: I then come back to clause 30 of the Edinburgh agreement which is essentially an indication that both Governments recognise that, if people in Scotland vote yes in the referendum, we have to work together to construct the delivery of the outcome that people have voted on. This will be the proposition that we put to people in 2014. Equally, if people vote no in the referendum, the Scottish Government must work with the UK Government constructively, which we have signalled we will do.

Q891 Lord Forsyth of Drumlean: Lord Chairman, may I follow up on that, because I am now confused? I am Standard Life, let us say, and I operate in Scotland and most of my customers are outside Scotland. A large part of my costs are compliance costs arising from regulation, quite appropriately. It is not clear to me how I am going to be regulated. We have got the point about the Bank of England and its macroprudential role, but is there going to be a Scottish regulator as well? If I have two regulators, will that add to my costs and complexity? As most of my customers are outside Scotland, might I not be tempted to simplify things by just moving south?

John Swinney MSP: There is an obligation, which we acknowledge, that we would have to fulfil our commitments to the EU in relation to regulation of the type to which Lord Forsyth refers. My point is that, in exercising that function, we would be doing so in a way that was designed to minimise any additional burden that would be applied on anybody operating in that sector.

Lord Forsyth of Drumlean: So there would be an additional burden.

John Swinney MSP: Not necessarily, because, as I said in response to Members of the Committee a moment ago, many of the regulatory issues that have to be dealt with are emerging from the European dimension, so the requirement to be compatible with that regime would be consistent north and south of the border.

Q892 Lord Skidelsky: Just a preliminary remark—I do not know whether you agree with it—on the whole tenor of the discussion: it seems to me that there is an obvious problem or difficulty. If you proceed on the assumption that Scotland will become independent, and if you are not to proceed on the assumption that it will not, that affects how much pre-referendum effort you make to establish a post-referendum condition. That is just a general observation. My specific question is: if Scotland were to become independent from the rest of the UK, some of the current UK stock of assets and liabilities would need to be divided. In similar cases in the past, most pertinently Ireland, the division of outstanding public debt was on a per capita basis. Do you think that that is a reasonable starting point?

John Swinney MSP: The point that Lord Skidelsky makes to begin with is important. There can be a great deal more progress made if all parties are prepared to do some preparatory work before 2014 on these questions. Clearly, that is an opportunity to be taken forward. In terms of the substantive question, the approach that we would say is appropriate in this respect is to recognise the distinction between assets and liabilities of the United Kingdom state and the geographical, natural and human assets and liabilities of the future independent countries of Scotland and the rest of the United Kingdom. If we focus solely on the assets
and liabilities of the UK state, a per capita distribution arrangement would strike me as a fair and reasonable approach.

**Lord Skidelsky:** We are talking of course of gross debt, and there the figures are clear. There is a stock of debt of the UK Government which comes to 75% of GDP or thereabouts. Would you say that you can divide the assets in a similar way? On the asset side of the balance sheet, would an independent Scotland be able to claim less or more of the stock of assets that are relevant to the national debt?

**John Swinney MSP:** There is clearly a material negotiation to be undertaken in that respect. It is possible to divide the assets and the liabilities in terms of the assets and liabilities of the UK state in a clear and agreed fashion. I can see how that is possible. Certainly, I can remember in my days in the House of Commons the start of the creation of the UK register, which I think was produced for the first time under the Labour Administration of 1997, and that is a clearly tabulated part of the process.

**Lord Skidelsky:** Just one last question: if an independent Scotland uses sterling and inherits a large initial stock of government debt on an agreed basis, would it run a risk of insolvency if sterling was created by the Bank of England and that amount of sterling would be inappropriate to the conditions of an independent Scotland?

**John Swinney MSP:** I do not foresee that. With the Bank of England exercising that function across Scotland and the remainder of the United Kingdom, I could not foresee how it would take that step in a fashion that would create those conditions.

**Lord Skidelsky:** Neither could I, but it was a question that I was asked to ask.

**Q893 Lord Shipley:** Could I ask you to say something about our planning assumptions about borrowing costs in the event that Scotland is independent? The global financial crisis has shown how important government borrowing costs are to the sustainability of public finances. What do you consider these borrowing costs depend on and what measures would an independent Scotland take to make sure that they were contained?

**John Swinney MSP:** Clearly, borrowing costs are a product of the financial health of the country and of its reputation for financial management. In that respect, Scotland, as I set out earlier, is in a stronger fiscal position than the rest of the United Kingdom, making a larger contribution to UK revenues than our population share would indicate. The financial strength of the country is positive in that respect. In terms of track record—you made reference to performance in terms of management of public finances under the devolved settlement—there would need to be in place a credible fiscal framework to provide reassurance and confidence within the market. That would clearly have an effect on borrowing costs. We would work to create the strongest platform of financial strength to ensure that we had sustainable borrowing costs.

**Lord Shipley:** Before the crisis began, Ireland, Spain, Portugal and even Greece had lower public debt-to-GDP ratios than the 75% of GDP suggested by the Institute for Fiscal Studies as an independent Scotland’s share on a per capita basis of UK debt. Scotland would be a new, small country in population terms and in terms of the size of the total economy. It would be inheriting a very large stock of public debt without a track record of debt management and repayment, and without its own currency. Might it not therefore face higher borrowing costs? Have you done any estimates of what those might be and do they cause you any concern?
John Swinney MSP: A lot of the ground of that question I think that I have dealt with in terms of the assessments that are made of the financial strength of a country. I have set out the detail in that respect in my previous answer. In relation to the question of credit ratings, almost two-thirds of the countries who have a AAA status from Standard & Poor’s have a population of less than 10 million, so I do not think that size of country is a particular determinant of some of these questions. What is important is the emphasis that we can attach to the design and delivery of an effective fiscal management framework. Lord Shipley made the point about currency. We would under our proposals utilise the pound sterling, which would provide the market with some strong reassurance about the contribution that the pound would make to our economic activity.

Q894 Lord Rowe-Beddoe: Mr Swinney, let me follow on from a phrase you used in response to Lord Shipley—“financial framework”. It has been said that good neighbours erect high fences. The IFS suggests that an independent Scotland should consider fiscal rules and architecture as a means of ensuring financial sustainability. Has your Government examined appropriate fiscal rules and architecture?

John Swinney MSP: Yes, and I fundamentally agree with the proposition that the IFS put forward. When I came into office as Finance Minister of Scotland, my predecessors under devolution had made a number of very substantial commitments in relation to PFI projects, for example, with no financial framework or parameters in place as to what proportion of revenue, for example, we would anchor to or consider appropriate to be supporting these investments. I have now put in place an architecture that will constrain the amount of revenue-financed investment that we can take forward, recognising that these rules have to be put in place. That is something that we have done under devolution. The Council of Economic Advisers who advise the Government recommended in 2009 that, if the country was acquiring greater financial responsibilities—as we are doing in the course of 2015, due to the passage of the Scotland Act—we should put in place some independent financial assessment of an OBR-type character. The Government is supportive of such a proposition. I think that there is a strong case for an approach as suggested by the IFS.

Q895 Lord Rowe-Beddoe: So you agree with their recommendation for an independent budget office. What about a fiscal rule that they say should target the cyclically adjusted balance, excluding oil and gas?

John Swinney MSP: There are a set of rules that would be beneficial to have in place. I was quite struck by the contribution to one of your Committee hearings from Professor Iain McLean, who said: “If I were John Swinney and if he were the first Finance Minister of an independent Scotland, I think I would beat a path to North Queensferry, knock on Gordon Brown’s door and say, ‘Please could you tell us how you devised and policed the golden rule and the sustainable investment rule, and how you would organise them if you were doing it again?’” If you will forgive me, I have no plans to go to North Queensferry for such a conversation, but I think that there is an important dialogue to be had about establishing those fiscal rules and, more importantly, sticking to them.

Q896 Lord Forsyth of Drumlean: I suppose that if you went to North Queensferry you could thank him for giving you so much money that you were able to balance your budget while he was Prime Minister. Could I just ask you about North Sea oil? It is commonly agreed now that if you had a geographical share of North Sea oil, the revenues would mean that your fiscal deficit as a share of GDP in an independent Scotland would be slightly lower than that for the rest of the UK. If we look at the work done by the IFS and the OBR,
assuming that everything remains the same, there would be a crossover in about five years’
time, where you were disadvantaged. Do you accept that? Is that not going to happen just at
the point where you believe that you have concluded your negotiations and set sail for this
bright new future?

John Swinney MSP: Certainly, the OBR estimates that Lord Forsyth cites are those OBR
estimates. Clearly, with all these questions, there are substantial and significant variables. For
example, I note that the OBR’s projection for the cost of a barrel of oil is $92 by 2017-18
under their scenario, whereas the International Energy Agency’s assessment is $120.

Lord Forsyth of Drumlean: What is yours?

John Swinney MSP: The assessment that I would be confident in is the International Energy
Agency’s. In that respect, there is clearly the potential for a different set of numbers to
emerge from these factors. I think it is also important to remember that the latest estimates
are that there are up to 24 billion barrels of oil and gas still to be recovered from the North
Sea. When you have an asset with a wholesale value of about £1.5 trillion, it still remains a
substantial opportunity.

Q897 Lord Forsyth of Drumlean: Just on that particular point, you can never believe
what you read in the Scottish press, but I have seen in the Scottish press quotations that an
independent Scotland would not be responsible for the clean-up costs of the North Sea—
the whole business of disabling and dismantling production platforms and so on and so forth.
Is that your position? If it is your position, how would that work? As I understand it, the way
in which those clean-up costs would be recovered is because they are allowable against tax
on the revenue that those companies would get, so when I read in the Scottish newspapers
that Scotland would not have to pick up the costs of dismantling and cleaning up the North
Sea, does that imply that you would not be giving tax relief to those oil companies for that
purpose?

John Swinney MSP: On the general point about the financial relationship and taxation
environment for oil and gas companies, the Scottish Government would be wanting to
provide assurance to the oil and gas companies about the continuity of arrangements, rather
than the rather what I could call volatile approach to financial arrangements for the oil and
gas sector that the current Government has demonstrated in its term in office. The second
point I would make is that clearly the issues of oil and gas decommissioning are a material
part of the long-term financial liabilities that would have to be addressed in terms of the
discussion that I had a moment ago with Lord Skidelsky.

Lord Forsyth of Drumlean: Yes, but how would that work? When you say “the long-
term financial liabilities”, that is a liability that at the moment is met by being allowable
against tax on future revenues. So my question is a very simple one. Does the first part of
your statement, which says that you would want to maintain stability, merge with the last
part of your statement, where you say that it would be a matter for negotiation? Either the
regime remains the same or it does not.

John Swinney MSP: We want to provide continuity and certainty to the oil and gas
companies. That is our key consideration—

Lord Forsyth of Drumlean: So the costs would be picked up by the Scottish taxpayer.

John Swinney MSP: The point that I am making is that, when we come to the discussion
about liabilities and debt, a whole host of material issues have to be borne in mind in terms
of, for example, where the benefit of the long-term oil and gas revenue has been over the course of the last 40 years or so. When I look at the analysis done by the Scotland Office, for example, it shows that, in terms of the creation of accumulated debt, Scotland was responsible for the creation of £41 billion of debt between 1980-81 and 2009-10. The United Kingdom’s contribution was £715 billion. Even if we had a per capita contribution of the UK’s £715 billion, which would be £60 billion, that is £20 billion less debt created by Scotland compared to the Scotland Office analysis.

Lord Forsyth of Drumlean: I am not asking about that—

John Swinney MSP: These things are all part of the mix, Lord Forsyth. They are parts of the mix that have to go into that discussion about the handling of all liabilities in that process.

Lord Forsyth of Drumlean: I am just asking whether, if I am BP, Esso or one of the other operators in the North Sea, I can take it that, in a future independent Scotland, all my costs of decommissioning will be allowable against tax and that therefore the costs will fall on the Scottish taxpayer. Yes or no?

John Swinney MSP: What I am saying is that the Scottish Government would have a vested interest in ensuring that we operated a supportive taxation regime for the oil and gas sector—

Lord Forsyth of Drumlean: Is that maybe, then?

John Swinney MSP: But we cannot ignore the issues of long-term debt that have been accumulated as a consequence of these wider issues.

Q898 The Chairman: Very briefly, because obviously we have had a very long session, let me ask this. In your speeches, you have suggested that an independent Scotland would introduce different corporation and personal tax rates from those in the rest of the UK. Can you explain what you mean by this?

John Swinney MSP: I am not sure that in my speeches I have made a case for different personal tax rates. The one exception would be the fact that I would not have supported the removal of the 50p tax rate in the Budget in March, but other than that I cannot think of another occasion where I have made such a speech, other than in 1999, when I was arguing for the use of the Scottish variable rate of taxation, but that was a long time ago. On personal taxation, the Committee will be aware of and familiar with the fact that, with the introduction of the Scotland Act, there will be different income tax systems operating north and south of the border. In relation to corporation tax, we have taken the view and still take the view that business taxation is an area where we can provide the opportunity to make Scotland an attractive place for investment. In the powers that we currently have on business rates, for example, we have the most competitive business tax arrangements in place within the United Kingdom. Obviously, creating a competitive business tax platform would be part of our interests to take forward.

Q899 Lord Levene of Portsoken: Mr Swinney, you are also reported to have suggested that policies for Scotland decided by those who live and work in Scotland would release an entrepreneurial drive leading to greater productivity and economic growth. Can you describe this more fully and share with us any evidence for this release of entrepreneurial drive? Are there differences in innovation and entrepreneurship between Scotland and the rest of the UK?
John Swinney MSP—Oral evidence (QQ 864-900)

John Swinney MSP: Part of what I envisage here, Lord Levene, is the utilisation of the point that I was making in my opening remarks about essentially combining different areas of policy to assist in creating a better climate for identifying solutions in our country. One of the areas where we have done a great deal of work—and I think that we have been very successful—is in creating a combination of interests between the innovation community within the business sector and our higher education institutions. That has been collaborative working that has been very successful. Add on to that the ability to deliver tax flexibility to encourage and incentivise that process and I think that has the potential to create real entrepreneurial flair. I have just recently launched an initiative to encourage the emergence of young entrepreneurs in Scotland. It is a relatively modest scheme, but it has had a quite overwhelming response from young entrepreneurs in Scotland. If we were able to add to that some other flexibilities through the tax system, I think that it could be similarly encouraging. The general point that I would make is that, in this space, the whole process of becoming, essentially, a country responsible for our own well-being under independence would create a very strong climate of financial responsibility and creativity as a consequence. I think that that would encourage the development of a great spirit of entrepreneurialism in Scotland.

Q900 Lord Levene of Portsoken: I have one final question, on which I think the whole Committee would like to hear from you. Would you like to take this opportunity to identify for us some of the economic benefits of independence for Scotland?

John Swinney MSP: I think that the economic benefits could be constructed out of the drawing together of some of the areas of policy for which we currently have responsibility. We can weave together a number of different elements of policy to create integrated solutions, but we then run up against barriers as a consequence of policy being reserved to the United Kingdom. If I think about employability, for example, we do a certain amount in relation to employability activities in Scotland, but we then invariably run up against some of the constraints of the UK tax and benefit system, where, with a greater degree of flexibility, we could deliver better solutions for the people of Scotland. That is one example where I think we would benefit. Secondly, in relation to the utilisation of tax measures, I think that there is an opportunity for us to customise particular tax measures to encourage the development of key sectors in the Scottish economy, such as in life sciences, where we have a number of critical connections between the business development community and higher education institutions to create some added value. Thirdly, I think the utilisation of the resources of Scotland to the benefit of the people of Scotland would provide us with the opportunity to create a very sound financial platform on which to build a more successful economy. Part of what concerns me is that our economic performance over the last 30 to 40 years in Scotland has been lower than that of the rest of the United Kingdom. I think that independence gives us the opportunity to rectify that imbalance.

Lord Levene of Portsoken: You are suggesting that that lower performance has been dragged down by the policies of the Government in Westminster.

John Swinney MSP: What has happened is that we have been unable to create all the solutions that I think we could create if we had the powers of independence to put our economy in a stronger place.

The Chairman: Thank you very much, Mr Swinney. It has been a long session, because there is a lot to cover. I am sure that it did not surprise you that quite a large part of the earlier questioning was on the issue of EU membership, because you take the view that what you have just described as the possibilities for an independent Scotland would depend on
Scotland being a member of the EU. Indeed, that is certainly the evidence that we have received from many businessmen. The chief executive of Aggreko, a major Scottish company, said, “Being part of the European Union would be the sine qua non of our having our headquarters and manufacturing facilities there” in Scotland. So clearly that is an important issue, and I am slightly surprised that, after all the discussion about the EU membership issue over recent months while our inquiry has been going on, it is only now that our correspondence with Mr Barroso has effectively flushed out a letter from the Scottish Government asking for talks. We will be watching that very carefully in the concluding moments of our inquiry. It would be helpful if you would very kindly give us the two or three notes that you have indicated that you would fairly soon, because we will be making our report in the first part of the new year. Meanwhile, thank you very much indeed for coming and for giving us such an amount of time.

John Swinney MSP: My pleasure. Thank you.
Weir Group—Oral evidence (QQ 676-697)

Evidence Session No. 13. Heard in Public. Questions 676 - 697

THURSDAY 25 OCTOBER 2012

Members present
Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Levene of Portsoken
Lord McFall of Alcluith
Lord Tugendhat

Examination of Witnesses

Keith Cochrane, CEO, Weir Group

Q676 The Chairman: Mr Cochrane, thank you very much indeed for coming. We are very grateful to you. We had hoped and expected that other business leaders would be able to join this session, but for various reasons they were unable to do so, so we are particularly grateful to you for coming. We are very anxious to hear from business leaders, who are a very important element in the debate on the economic implications of independence. We have of course had representative organisations such as the CBI and the IoD talking to us, and we are seeing more business leaders in London. Would you like to make an opening statement or shall we go straight to questions?

Keith Cochrane: No, I do not have an opening statement, other than to say that I welcome the opportunity to participate in your hearings. Certainly from my perspective, as someone who has worked in the Scottish business community all his life, this is a very important issue, and one with which business should fully engage, while recognising that it is just one of many stakeholders in the overall debate.

Q677 The Chairman: We would very much agree with that. Let me start with a general question. What do you see as the main commercial, financial and economic implications of an independent Scotland for a Scottish-based multinational manufacturer such as your company?

Keith Cochrane: Perhaps before I answer your question I could put into context the nature of the Weir Group’s operations in the UK. We have around 1,500 employees across the UK. We have two manufacturing plants south of the border, in the north of England.
Scotland, our headquarters function here in Glasgow with services operations in Alloa and East Kilbride. We serve not just the Scottish marketplace but the UK-wide marketplace. So we have a range of business activities on both sides of the Scotland/England border. In terms of your question, for us the two key areas of focus are, first, ensuring that Scotland remains an attractive base for the headquarters function of a multinational business; and, secondly, ensuring in the context of our UK business that there remains one single market across the UK, which enables free movement of products, goods and people across the border and does not impinge on our ability to continue to develop and grow our business. Specifically, to go to the next level of detail, there are probably three or four major areas on which we are particularly focused. The first is the risk arising from the potential break-up of a UK-wide corporation tax base. The second is the risk of regulations starting to diverge on both sides of the border. That is linked, thirdly, to the costs associated with that. Our final concern is to maintain our ability to attract, retain and recruit the best people for the job, irrespective of nationality, from a Scottish headquarters base.

The Chairman: That is very clear and helpful. We will explore some of the issues in detail.

Q678 Lord Levene of Portsoken: I would like to get something clear in my mind. You said that you had 1,500 employees in the UK. Is that right?

Keith Cochrane: That is correct.

Lord Levene of Portsoken: Our brief says that you have about 13,000 employees around the world.

Keith Cochrane: That is correct.

Lord Levene of Portsoken: On that basis, would I be right in thinking that your business in the UK overall, and in Scotland in particular, is a relatively minor part of your whole business?

Keith Cochrane: Our overall UK operations account for less than 10% of our total revenue. Our focus is very much on minerals, on the oil and gas markets and on the power market. We are a long-established business with 140 years of history based here in Glasgow. The business has evolved over time and our philosophy has been to stay close to our markets through the development of our operations. Of course, in the UK context, our manufacturing plants in England support the minerals market throughout Europe. Our valves plant outside Huddersfield is focused on the nuclear market, both here in the UK and elsewhere. Obviously in Scotland, our interest is in the power market and the oil and gas markets. They are the focus of our non-head office-based activities.

Lord Levene of Portsoken: So you would be concerned about what happened in the independence debate, but in relative terms it would not be a very big issue for the whole group?

Keith Cochrane: In the context of the total group, I think that you are right. In the context of our operations in Scotland and our ability to operate across the UK as freely as we can today, questions around independence come to the fore.

Lord Levene of Portsoken: This is not a leading question, but could that conceivably mean that, should Scotland become independent and you have more business in the rest of the UK than in Scotland, you might decide to move your headquarters south rather than leave them where they are? Obviously, it would depend on the conditions.
Keith Cochrane: At this point in time, we have operated very satisfactorily with a head office for our global operations based in Glasgow. What is most important to us—and the reason I mention head office and headquarters functions as being very relevant—is to ensure that the costs of operating a global business, or indeed a UK business, from a Scottish headquarters location do not force us to consider other options. It is not something that we seek or desire; my entire business career has been based in Scotland. At the same time, we would be under an obligation to our shareholders, if we found that there were barriers imposed or that there was an inability to run our business as effectively as we might otherwise do, to reconsider our headquarters location at some point in the future, depending on the specifics of the environment at that point.

Q679 Lord Forsyth of Drumlean: Mr Cochrane, does it worry you that so many issues that directly relate to the business environment and the costs of doing business here in Scotland appear to be left to be resolved after people have voted on the issue of whether there should be an independent Scotland?

Keith Cochrane: From my perspective, and from the perspective of my business, I think that it is a concern. It is important that the facts are presented to the Scottish electorate. One of my reasons for seeking to engage in the debate is to ensure that the right questions are asked—and, hopefully, answered. We all recognise that inevitably some issues would have to be resolved post any independence referendum, but providing as much information as possible at this point and over the next couple of years prior to the referendum taking place will be in everybody’s interests. Therefore we will continue to raise issues as appropriate and seek to engage with business and the community in trying to get answers to those questions.

Lord Forsyth of Drumlean: For example, Simon Walker of the Institute of Directors gave evidence to us and said that the institute was not going to take a position either way on the merits of independence. As I am sure you are aware, a number of business leaders have pretty robust views that they express privately but not publicly. What do you think is making business leaders so reluctant to ask these difficult questions and to draw the public’s attention to some of the issues? Sadly, they have far more credibility when they do so than politicians.

Keith Cochrane: There may be a combination of factors at work. Traditionally, private sector business has generally not sought to engage in politically contentious debate, preferring to leave that to politicians and broader stakeholder groups. It may be the length of time, as we still have two years to go and a lot of things can happen in that period. It may also be that business leaders are keeping their powder dry until closer to the point when the decision is taken. In my discussions I have noticed a growing awareness of the issue. The agreement reached last week may act as a catalyst to engage others in the broader debate that needs to take place. The more debate and the more questions that can be both asked and answered over that timeframe, the higher the quality of the ultimate decision-taking will be in the referendum vote.

Q680 Lord Forsyth of Drumlean: Perhaps we can move on to one of the issues, which is the currency. Let us imagine that there has been a yes vote for an independent Scotland. Which currency do you think it should adopt and what would be the implications for someone such as you who is running a long-established and successful international business based in Glasgow?
**Keith Cochrane:** We would look at this question much as we would look at any business issue. To change the status quo, the benefits have got to outweigh the risks. When I look at the question of a currency, I struggle to see any reason why we would not wish and seek to continue to adopt the pound sterling as the currency of an independent Scotland. It is something that we are familiar with from a reporting point of view and from the perspective of our treasury systems. To come back to one of my earlier points, I am keen to see that the UK, irrespective of the independence referendum vote, remains a single market. If we either adopt the euro or a separate Scottish currency vis-à-vis England and the rest of the UK, it would create another potential barrier and additional volatility through foreign exchange risks, which would be unnecessary and would start to inhibit the ability of business to benefit from the entire UK domestic market.

**Q681 Lord Levene of Portsoken:** You said that you would be in favour of sterling being retained because it would cause the least amount of disruption. If that happened, and unless it was done from without, on the basis that Scotland just continued to adopt sterling, there might be an agreement under which the Bank of England would still have a role as lender of last resort or as the regulator for Scotland. Do you think that that would increase business confidence, if Scotland had moved to independence? In other words, would the addition of the Bank of England help internally in Scotland, and externally with the client base of Scottish industry?

**Keith Cochrane:** Undoubtedly it would be helpful for the Bank of England to continue to have a role going forward, in terms of the credibility that it would bring as a lender of last resort. The reality is that if the agreement were not in place there would need to be some form of very structured and formal arrangement to give confidence in Scotland continuing to use the pound sterling. Otherwise, as we have seen right across Europe in recent times, voids can form. It may be just a perception of the markets that voids have formed; there may be no legal substance to it. Particularly in the immediate post-independence phase, maintaining confidence in the currency and confidence across the business community, and ensuring that the overall competitive environment was sustained, would be absolutely critical from my perspective.

**Q682 The Chairman:** Do you think therefore that it would be essential from the point of view of the Bank of England and of the taxpayers in the rest of the UK that there was a strong fiscal pact before the Bank took on the role? Does not recent European experience underline the importance of achieving that?

**Keith Cochrane:** This is not my specialist subject at all, but, in terms of the logic of the European experience, and in terms of ensuring absolute clarity about respective roles and responsibilities, that would be helpful. What form the fiscal pact might take, I do not know; I do not know enough about the subject matter to comment. However, some form of formalised arrangement would undoubtedly be helpful, both for Scotland and for the rest of the UK, to avoid any issue of doubts emerging, given the way that we all know markets operate.

**Q683 Lord Forsyth of Drumlean:** Could you expand on how you think it might be helpful to the rest of the UK? I can see why you might want to have a situation where the Bank of England was involved, for reasons of stability and everything else. However, I cannot imagine why taxpayers in the rest of the UK—whom we are talking about when we talk about the Bank of England—would want to provide money as a lender of last resort to what had become a foreign country. In terms of the Lord Chairman’s question about a fiscal pact,
the experience with the euro, where we had the Maastricht criteria, is hardly encouraging. The two strongest countries, France and Germany, were the first to break the Maastricht criteria, and it has proved very difficult to enforce a fiscal pact. You are financially literate. What would be the mechanism by which you would ensure that any pact was conformed with? Why would anyone in the rest of the UK want to commit resources in this way, unless a substantial premium was paid by Scotland?

Keith Cochrane: Perhaps I can take your second point first. On the fiscal pact, I would hope that lessons would be learnt from recent European experience in terms of the breadth, scope and coverage of the pact, to ensure that the risks were minimised. That is something that would obviously need to be worked through by both Governments and the central bank.

Lord Forsyth of Drumlean: Sorry to interrupt you, but the lessons that are being learnt in Europe are that you need to have more integration. Here we are doing the opposite.

Keith Cochrane: Absolutely, but it would depend then on how broad the fiscal pact was. I have seen a range of scenarios outlined about how the pact might be structured. Clearly there are current proposals before the European Union for greater budgetary control and integration. That would have to be considered and thought through as part of a potential solution. It would really hinge on how narrow or broad the fiscal pact was. To maintain credibility, it would need to be a credible fiscal pact, and would need to be seen in the context of recent EU experience.

On your earlier point about why the rest of the UK would seek to support Scotland, I guess that it would be to protect against the unintended consequences of another country using your currency, and the potential issues that may or may not arise from that. It is probably far better, particularly in the very volatile economic world in which we all live today, to have a structured framework so that everyone understands the environment in which they are operating, rather than leaving it to chance or risk. I would have thought that that would apply as much to taxpayers, and to the rest of the UK, as it would to Scotland.

Q684 Lord McFall of Alcluith: Mr Cochrane, I am delighted that you have come. There is a feeling that we lack an evidential debate here; it is important to get that on the record. Further to Lord Forsyth’s point, if you were the Chancellor of the Exchequer in Westminster and someone came along and asked you to be the lender of last resort to Scotland, would you view that with equanimity?

Keith Cochrane: It would depend on the terms on which the proposal was presented. As a free option, then absolutely, you would say, “Why would I be willing to do this?” But I would look for some form of quid pro quo. That may take the form of some of the proposals put forward by the EU in terms of budgetary power across Europe. It may take some other form. As I say, I am not a specialist in this area. I am thinking about it instinctively as a business person who has a limited understanding of these issues.

Lord McFall of Alcluith: I understand that and I do not want to push you. As a business person, do you see quite a big risk element there?

Keith Cochrane: This goes back to what I was saying. You look at everything from a business point of view through the risk/reward relationship. There may be some risks to the rest of the UK by not entering into a fiscal pact. I may not understand what those might be, but I would want fully to understand them. That is the trade-off relative to what you would require or request from an independent Scottish Government.
Lord McFall of Alcluith: The issue of different rates of corporation and personal tax has been raised in the past few years. For example, the Scottish Government have looked to the Republic of Ireland and said that they, too, want different corporation tax arrangements. The IoD here has welcomed tax competition. How do you view a different rate of corporation tax from Weir’s perspective? Would it be a catalyst for an independent Scotland, or do you agree with others that it would be a race to the bottom?

Keith Cochrane: It is pretty simplistic to think about corporation tax just in the context of the absolute tax rate. How you apply that tax rate can in many instances have a greater impact on the overall tax bill that a corporation pays than the actual rate. The whole corporate tax issue needs to be considered in the round. I will give you a couple of examples as they would apply to our own business, and maybe to other businesses that operate in Scotland, in the UK and across the world. One thing that we would be very sensitive to is the loss of group relief. At the moment, as you may be aware, there is an ability to offset losses in certain parts of a UK organisation against profits in other parts before you prepare a consolidated UK tax return. If we had two separate tax jurisdictions, that ability would go away. I am not aware of any other country that operates a form of group relief on a cross-border perspective. I should put that in context, particularly for headquarters functions, which as a rule, typically—I have to admit—do not tend to be profit-making. They are the cost centres from which decisions are taken. Against that backcloth, there is a scenario out there. We would need to understand all the reliefs and there may be ways to militate against this. However, at face value there is a scenario in which, if you have a loss-making operation in Scotland, of whatever variety, and profitable businesses in England, and in overall terms you are a net corporation tax payer, you might lose the ability to use those losses against the English profits, which would mean that you would end up paying more corporation tax.

To go back to the whole cost-competitive issue, you would have to think very carefully about some of the unintended consequences of breaking up the UK corporation tax base.

I suggest that two other areas are worthy of being highlighted. One is the area of international tax arrangements. There is a very structured approach to international tax in the context of HMRC today. One would need to understand whether that was going to change and, again, cause additional costs to be incurred by our business and by other businesses in a similar situation. Trading across the UK is another area. The key issues are divergence, the need for different tax systems and the need to break down where people spend their time. For example, we have a service centre and management base in Alloa that provides power outage activities to all the nuclear plants across the UK. If those people are now going to spend a meaningful part of their year in another tax jurisdiction, will that mean that they are taxed in two different countries? If so, how would the double-tax arrangements work? There is a lot of detail behind the tax question that needs to be carefully thought through. There is a lot more to it than just saying, “We are going to have a different rate from you”, and hoping that that will drive further economic investment—if for no other reason than that it is difficult to assume that there would be no reaction if, for example, Scotland were to reduce its corporation tax. I cannot see the rest of the UK allowing the north of England in particular to be impacted by that without some form of response in due course.

Q685 The Chairman: That is very interesting, Mr Cochrane. Are you raising those issues in public and in representations to the Scottish Government, or are you waiting until the vote takes place to say that these are critical issues for negotiation?

Keith Cochrane: No, we are engaging in debate with both the Scottish and the UK Governments. We responded to the consultation papers that both Governments put out
earlier this year. The detail behind this is one of the critical areas. Again, it goes back to the whole single-market concept that I talked about. The more that we impose barriers within the UK, the more it will detract from the ability to grow and develop other businesses for the common good.

Q686 Lord Forsyth of Drumlean: I think that I have followed this debate really closely, but the points that you have just made about offsetting losses cross-border, and about headquarters, are completely new to me. I had not thought of them before. It is crucially important to Scotland. Our history over the past 20 years, partly because of internationalisation, has resulted in a situation where you are pretty unusual in being a Scottish company with headquarters in Scotland. One can think of others such as the Royal Bank of Scotland which are very important. Do you think that business organisations such as the CBI and the IoD could be a bit more—“aggressive” is not quite the right word—active in putting across some of these points? As the Lord Chairman said, it is no good having these discussions about taking a decision to go ahead with break-up if people are not informed. This is not a narrow point about how you will do business. This is about how Scotland will retain corporate decision-makers in Scotland.

Keith Cochrane: It is certainly a point that we have raised with the CBI. We continue to engage with CBI leaders on these questions. I know that the big four accountancy firms are very aware and conscious of this issue, along with a broader range of questions around the whole structure of the tax base. The point that you made about headquarters functions is very important. We all recognise the value that headquarters functions bring to a local business environment. Scotland has lost quite a number of headquarters functions in recent years, through takeovers or for whatever other reason. We want to retain decision-making and a critical mass of skills in Scotland. In our own case we will spend about £15 million a year with professional advisors undertaking due diligence with all the acquisitions that we look at around the world. There is real value to be had from where a headquarters function is located. My concern is to highlight the question of headquarters functions, and of not putting barriers in the way of these functions being placed in Scotland, which has a relatively small domestic market. I will continue to raise the issue as appropriate over the coming months and years.

The Chairman: I am very glad that you flagged that up to us. In relation to Lord McFall’s opening question about what you would do if you were Chancellor of the Exchequer, I was reflecting that if Scotland were independent, we would not have had two recent Chancellors of the Exchequer; they would not have been there.

Q687 Lord McFall of Alcluith: Let me follow up that fascinating answer, Mr Cochrane. With other witnesses this morning, I referred to Melanie Reid’s article in the Times, which stated that the debate in Scotland will be conducted on two levels—the emotional and the functional—but that at the end of the day it will boil down to “stirrings of the heart”. The evidence we received from politicians and others in Edinburgh yesterday gave us the feeling that the evidential element is going to be secondary, as Ms Reid indicated. I challenged the IoD and the CBI this morning to ensure that we do get that evidential debate. Given that you are a member of the CBI, it would be good for politicians and the public if we got fora where issues such as this could come out. I suggest that if you leave it to the politicians, you will not get that. Could you take that message back to the CBI?

Keith Cochrane: I certainly can. It is something that I personally am passionate about. This is such an important issue—a game-changing decision—for the entire Scottish business community. Of course, there are views on different sides. We all need to understand the
facts before we make our final views known at the ballot box. Having the debate is absolutely fundamental. Certainly from my perspective, it is something that I am willing to spend time on. I speak to other Scottish CEOs and business leaders. We are engaged in debate with the Scottish and UK Governments on the issue. We certainly intend, in the best way that we can as one individual business, to raise some of these issues.

**Q688 Lord Tugendhat:** How important to the Weir Group is continued Scottish membership of the EU? And how important is it to the Scottish economy itself?

**Keith Cochrane:** I will take that first from a Weir perspective, recognising the activities that we have in Scotland, which are principally service-oriented into the North Sea, or into the power markets across the UK. Maintenance of a single UK-wide marketplace is for me the number one priority, even ahead of a European context, when I look at Weir operations today. Beyond that, the next point that I would make is that it is critical that Scotland and England are in the same position vis-à-vis the EU. Otherwise, we would risk breaking up the single market. The EU is an important market from a broader UK perspective, but the most critical element is the single market; the free trade area is the critical component to retain. There is a lot of debate on broader questions of EU membership. I do not propose to take a view or to engage in that debate, but the most critical thing for Scotland, and indeed the whole of the UK, is to ensure that the free trade arrangements are retained, thereby supporting our ability to grow and further develop our businesses.

**Lord Tugendhat:** If I may say so, that is a very interesting reply. What comes through very clearly is your view that it is the integrity of what is currently the United Kingdom market that is the most important thing, and that the way in which EU membership should be looked at from a Scottish perspective is through the prism of maintaining the UK-wide single market. That is the priority; as regards the EU, you would want to remain in whatever position England was. If England were in, you would want to be in; if it were out, you would want to be out.

**Keith Cochrane:** It is difficult to foresee a scenario—although I guess it could happen—where we would take different positions, with one being in and one being out, because of the importance of cross-border trade. There may be a way round it that I am not familiar with, but I think that having the ability to maintain that flexibility and freedom in the marketplace between Scotland and England is critical. Could that be achieved if one were in and one were out? I do not know enough about it, but I make the point more broadly that when I look at Scottish business-wide interests, as I understand it the biggest single market for Scotland is England. That is why that is still relevant in a Scotland-wide context. Clearly the European markets are very important for Scotland, but in the context of trading more than anything. Again, the European relationship and maintaining a single, Europe-wide free market is something on which it is worth focusing. We should ensure that it continues, whatever form our EU membership takes.

**Q689 The Chairman:** If Scotland became independent, it is likely that the economy would become more dependent on oil revenues, not least for public expenditure, given the loss of the Barnett formula that would follow negotiations. Do you think that this would have a detrimental impact on the non-oil sectors of the economy, and in particular on the businesses there?

**Keith Cochrane:** I do not believe so. There are some very strong, non-oil economic sectors—for example, the food and drinks industry—that would not be impacted by the specific dynamics of the oil and gas markets. The engineering sector in Scotland has a long
tradition of manufacturing and engineering. Again, I do not see that necessarily being taken away. When I look for differences between our operations in Scotland and those in England, in terms of the markets we serve, frankly, there are none. There is a lot of debate about the markets moving in different directions, but for me it is more a debate around London and the south-east, and a recognition that London is operating in a global marketplace, as distinct from the rest of the UK, rather than necessarily a Scotland/England thing. Therefore, in that sense, the issues that our manufacturing plants in Yorkshire have are exactly the same as those that our Scottish-based operations have. It is more a question of how you balance the financial services and the global focus of London against the rest of the UK, to ensure that the marketplace does not become completely lopsided.

Q690 Lord Tugendhat: Could I query that, please? If one looks at Australia, one sees that when the raw materials sector is doing very well, the Aus dollar rises in value and the rest of the Australian economy has a lot of difficulty with its pricing. We have seen in recent years the manufacturing sector in Australia being badly hit by the rise in the Aus dollar as a result of the strength of the raw materials sector. In the case of an independent Scotland, obviously oil would be a much larger part of the Scottish economy than it is of the UK economy. So if there was to be a booming oil market, it would impact on Scotland; and if there was to be a declining oil market, that, too, would impact on Scotland. I recognise that you would be using—or least you hope that you would be using—the pound sterling, but the link between your raw materials dependency on the one hand and your currency on the other is important to protect you from the sort of fluctuations that we have seen in Australia.

Keith Cochrane: I think that that is fair. As a business, we have some 1,500 employees focused on the minerals market in Australia, so I am very familiar with some of the challenges that Australia faces as the minerals market dynamic starts to change. It goes back to currency. The reality in the context of the pound sterling is that that is a challenge that the UK in totality has faced over the past 30 to 40 years, so I am not sure that the dynamic would fundamentally change. Certainly, if one were to say that Scotland would have its own stand-alone currency, I take the point that we would have to carefully think through how we would manage the consequences. The related question, if I may draw another analogy with Australia, concerns a skilled workforce and labour. Shortage of skills in the oil and gas base in Aberdeen has been a recurring theme for a number of years. It is a broader challenge that Scotland has in terms of ensuring that the right skills are available to support industrial and economic development. In the context of a stand-alone Scotland, does that fundamentally change? I am not sure that it does, to be honest.

Q691 Lord Forsyth of Drumlean: I am not sure that I completely understood that point. If you are using the pound sterling and if the oil price has gone up and there are larger revenues coming in from the oil sector, because you do not have an exchange-adjusting mechanism, will it not ultimately result in distortions in the economy? For example, wages in businesses that are oil-related or that are benefiting from this largesse will be pushed up, and traditional industries such as manufacturing and engineering will find that they are having to compete unequally.

Keith Cochrane: I am not sure. It may be because of the specifics of Scotland—Aberdeen is in the north-east, whereas a lot of other manufacturing and economic activity is based in the central belt. I am not sure whether anything would change fundamentally, because you could argue that we are in that position today. Clearly we have been in a period over the past year or two where there has been buoyancy in oil prices. The market has been stretched in
terms of skills availability, in Aberdeen and in the north-east generally, because of that. That has not impacted us in terms of our operations down here in the central belt.

**Lord Forsyth of Drumlean:** But of course, in an independent Scotland, oil revenues would be a bigger element in a smaller country. You would not have any of the transfer payments and so on. Perhaps I could broaden my question. As we are now in Scotland, everybody is agreed that we seem to be remarkably poor at generating larger businesses, and getting small and medium-sized businesses to develop and grow. Some people have argued that in an independent Scotland this would—in some way not defined—release energy and make us much better at it. Why do you think that Scotland has been, relative to the rest of the UK, so much less effective in developing small and medium-sized businesses? Do you think that any of these factors would be altered by Scotland becoming independent?

**Keith Cochrane:** I am not sure that Scottish independence per se would immediately trigger a surge in entrepreneurial activity. It is more about having the right skills, the right market access and the right environment that encourages and stimulates entrepreneurial activity. Some of Scotland’s leading entrepreneurs who have emerged over the past 15 to 20 years—I have worked with some of them in my career—have not operated in a merely Scottish context; they have operated in a UK-wide context. Again, while there may be some benefits from policy initiatives that might be introduced by an independent Scotland to stimulate activity, one would need to think through the implications of there no longer being one single, large domestic market, and whether that would operate in the opposite manner. I will give you a straight answer; I do not think that it is a straightforward question to give a yes or no to. There are pros and cons going both ways. Fundamentally, will independence drive entrepreneurial activity? No, it will not just happen because everybody wakes up one morning in an independent country. It takes a lot of effort and initiative, and you have to have the right capability and skills at grass-roots level to stimulate that climate.

**Q692 Lord Levene of Portsoken:** We have heard that, if Scotland votes yes in the referendum, clearly negotiations would have to follow on a range of very complex economic issues. These negotiations could take years. How do you view the prospect of an interregnum? Would it be damaging to business?

**Keith Cochrane:** You would have to view that with concern, both in the context of the distraction it might cause to our focus on economic development, and of the uncertainty that would inevitably exist about what form the final outcome of the negotiations might take.

**Q693 Lord McFall of Alcluith:** Economic issues to be negotiated would include the division of assets and liabilities, from the national debt to pensions, North Sea oil, defence and so on. These are obviously matters for government, but business would be affected by the process. Professor John Kay, who is on the Scottish Government’s Council of Economic Advisers, has said that negotiations would be long and protracted over many years. What advice do you have for government or others in terms of how business would be affected, and of the areas in the negotiations where government would have to be very careful?

**Keith Cochrane:** The major areas where Governments on both sides should focus from a business point of view are around the question of corporation tax—and indeed personal tax—arrangements between both countries, to ensure that there is absolute clarity about the taxation basis for individuals and for corporations. An interesting second issue, which I am not sure has been raised before, is around the question of private sector pension benefits. Public sector pensions have been talked about in a number of different guises, but a lot of private sector corporations, including our own, have one UK-wide pension
arrangement. Will that have to be split up? How will it be split up? I do not suggest for a moment that the following would apply to the Weir Group, given our own financial standing, but perhaps thought would need also to be given to pension protection arrangements. The Pension Protection Fund is in situ at the moment to cover funds or companies that fail. How would that operate if pension funds were split up in a UK context? There are some interesting questions there. Fundamentally, it is about trying to maintain that free, single domestic market, to minimise the degree of divergence and additional cost that would be imposed on business, or to provide offsetting means to counter that.

Lord McFall of Alcluith: Forgive me if I am taking you too far, but would people say, “We want dual nationality”, or ask to be termed English or Scottish or whatever? Could you envisage that taking place?

Keith Cochrane: An interesting concept that may work in the context of the rest of the UK and Scotland would be almost a European company. Perhaps there is some mileage in considering something like that, with companies benefiting from and effectively straddling different jurisdictions. That is pretty much the way things operate today. I guess that that would be subject to debate and dialogue between Governments.

Q694 Lord Tugendhat: I have been very interested in the way in which you attached so much primacy to the integrity of the United Kingdom economic space, if I may put it that way. I followed your reasoning very closely. Given that Scotland is more or less 10% of the UK and would therefore be much smaller as an independent state than the other independent state, when it comes to the degree to which you would maintain the integrity of the market in all its forms—you showed that it is not just a question of the movement of goods and people but involves pensions, benefits and all kinds of other things—the net result would be that political independence would be economically very circumscribed. Do you accept that proposition?

Keith Cochrane: I think that I need to be very careful how I answer that question. It would be an area worthy of debate over the next two years to understand exactly what independence means—let us put it like that.

Q695 The Chairman: You referred to pensions regulations, but in your opening statement you talked in particular about the divergence of regulations as a whole. I would be interested to know which areas of regulation you are thinking of in particular.

Keith Cochrane: One area is barriers to trade. I am looking—very selfishly from a Weir Group perspective—at the transfer of products, people and services across UK national borders. I am looking at anything that imposes additional costs on business, such as different forms of tax—and clearly there would be different tax systems, so that would be a cost you would just have to bear. Clearly, minimum differences in tax rates would be of benefit to business. Our company is listed on the London Stock Exchange, so understanding how Scottish commercial and business law applied to companies that were listed in what would then be a foreign jurisdiction would also be relevant to us and to others in a similar position. Then there is the whole panoply of regulations that impact business activity. I recognise that Scots law is different from English law, so there is a degree to which we work within that. However, if you look at the broader business law and commercial environment, there are probably more similarities than differences between Scotland and England at this juncture. That is certainly something that we would seek to retain going forward, irrespective of the referendum outcome.
The Chairman: I do not want to impose any further on you, but if you have any thoughts about other areas of regulation that would impact on your business, it would be very helpful if you would write us a short note.

Keith Cochrane: I will certainly give that some thought.

Q696 Lord Forsyth of Drumlean: I have not really thought this through, because the thought did not enter my brain until you made the point about pensions, but presumably the tax liability in relation either to employers’ or employees’ contributions to pension funds would follow the geographical location of the employee and the tax regime that applied there. However, if you had a UK-wide pension fund and the tax regime were changed in some way, for example to limit employers’ contributions that were allowable against tax, or to change the rules on tax-free lump sums and so on, presumably that could have a knock-on effect on the contributions that the employer would need to make to the overall pension fund, albeit that Scotland’s share would be only 10%. How would you as a chief executive view that possibility and risk? How would you limit the risks of changes of that kind?

Keith Cochrane: The simple answer to your question is that, yes, there could be an impact. How tax relief is applied to pension contributions north and south of the border would be a factor that we would have to address and could have implications on the funding of pension schemes. How you would address that risk is a really difficult question, because at the end of the day if legislation is imposed, business will comply. Therefore, frankly it would be an additional cost. It is not even an additional cost that you could avoid, particularly if it were a historic liability in the form of a deficit that had been built up over time by your Scottish or English workforce. You would be caught with that cost; there would not be a lot you could do about it. However, the whole arena of private sector pensions is worthy of thought, because of the implications for funding the deficit that many companies find themselves in. How will the funds be divided, who is the ultimate backstop protector of the pensions of the employees when companies go under, what are the future private sector pension arrangements, and will they start to diverge over time, based on the different approaches that may be taken by the different Governments?

Lord Forsyth of Drumlean: This may be a ridiculous example, but there are people who argue that the ability to take a percentage of the pension fund as a tax-free lump sum should be ended. For the sake of argument, if the Scottish Government made a tax change of that kind, presumably some companies with employees throughout the UK would have employees who were coming up to retirement in Scotland. If they moved south of the border, presumably the tax rules there would apply, and they would be able to get their tax-free lump sum. Or do you think that the rules would have to be aligned? They would have built up the sum with a certain expectation, but by moving from one part of the United Kingdom to another they would be bound by different rules. I realise that that is very speculative, but it could create all kinds of difficulties for people reaching retirement if there were different regimes north and south of the border within a common United Kingdom fund.

Keith Cochrane: There is no question but that it is an area of considerable complexity as to what the potential scenarios could be. I am probably not the best person to comment on them; I would not claim that pensions were one of my specialist subjects. Again, it is an area that needs to be thought through as to what the potential scenarios might be. It may be that there is an entirely acceptable way through this. I am certainly not saying that this is necessarily a bad thing. All I am saying is that it is an area of complexity that needs to be
thought through carefully, because, again, we have to be aware of the potential unintended consequences that might arise and impact individuals.

**Q697 Lord Levene of Portsoken:** Mr Cochrane, sparing your blushes, it seems to me—some of my colleagues might agree—that we have probably had the most well informed responses to our questions from you. Does it worry you that there is so little informed debate going on in Scotland? From what we hear, there is a lot of emotional discussion, and because of that, you might get plunged into a situation where people have not been able to see the true implications of what is a massive decision. If that is so, what are you going to do about it?

**Keith Cochrane:** The reality is that, looking at things through a Scottish lens, until last week’s agreement, the focus was very much on what would be the terms of the referendum, when it would take place, and what would be the form of the agreement that the UK and Scottish Governments had reached. I would certainly hope that now that it is out of the way, the focus can turn to the substance of the debate. As I said, there are many questions, certainly from our perspective. In many ways, agreeing to appear before the Committee today was in part driven by my desire to help Scottish business engage in the debate and recognise that there are a lot of important issues. We do not have all the answers. It may be that some issues can be quite satisfactorily resolved. However, it is critical to have this debate. Certainly, in between doing the day job, we as a group will continue to engage with this and participate in the debate with both Scottish and UK Government Ministers.

**The Chairman:** I do not want to delay your day job any longer. I certainly echo what Lord Levene said on behalf of all of us. We have found this an extremely helpful session. It is particularly important that businessmen with your wide international experience of business activity should enter into the debate. It has certainly occurred to us—which is why we have endeavoured to get more people like you to give evidence to us—that this must be a very important part of an informed debate for the general public, not only through us but more directly. For that reason, we particularly thank you for giving up your time today.
The Chairman: Perhaps I ought to say at the beginning that we are being televised. Today’s witness is Lord West of Spithead, who has had a most distinguished career in the Navy and ended as First Sea Lord and Chief of Naval Staff, and has of course also been a Minister responsible for security and counterterrorism in the Home Office, as we all know in this House.

We have had a response from the Secretary of State for Defence, who we invited to be a witness, and he has declined because he believes that there is nothing that they can add to what they have given to other Select Committees. He says in his reply to us that “We are not making plans for Scottish independence”. This Committee decided to take up this subject because we felt it very important that all the economic implications—of course, there are very big economic implications in defence—should be properly considered and put before the voters before the vote in the referendum. Given that we do not have the Secretary of State for Defence, we are particularly grateful to you, Lord West, for appearing before us today.

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in front of us today. Do you want to say anything at the beginning, or shall we go straight to questions?

Lord West of Spithead: Could I just make a very brief—I promise you, it is very brief—statement to put some of the thoughts in context? First of all, I am very pleased to be before the Committee; thank you very much for inviting me. I believe that the damage to our islands’ defence and the economic costs, particularly to Scotland, of separation, have not been properly exposed and, indeed, that there have been attempts to hide the impact from the Scottish people. I can talk about details of that later if you want. There are, of course, many variables—it is very difficult to actually work out some of these costs and things—but it is quite likely that over 10,000 jobs would be lost in Scotland. Bases would close. I have spoken to a number of defence firms that have parts of their organisations in Scotland, and they would all close in Scotland and move south; that is what they have said to me. I asked them why they had not come out and said that publicly, and they referred to a climate of fear within Scotland and that they cannot say anything, which I found quite remarkable.

I am also concerned, from what you said, that our Government say they are not doing any contingency planning, because they say separation will not happen. If that is really so—that they are not doing any—I think it is a dereliction of duty. There are huge implications for the United Kingdom. I know jolly well that, were I the First Sea Lord today, I would turn a Nelsonic blind eye to such instructions from the Secretary of State for Defence and I would set up a black team to work out all of the options and possibilities for, for example, our nuclear deterrent. These are issues that are much too important, I believe, to suddenly do at the last moment on the back of a cigarette packet. That is really all I have got to say.

Q845 The Chairman: We will be pursuing a number of these issues during the course of our hearing with you, and I repeat that we are very grateful to you for coming. Can I start by picking up some of the things that you have previously said? You have previously suggested that Scottish independence could lead to the British nuclear deterrent being given up altogether, because the cost of replicating the nuclear bases in the rest of the UK would be too great. Perhaps you would like to comment on that. In addition, would it be feasible to move the nuclear deterrent facilities on the Clyde elsewhere in the UK? How much would it cost, and how likely is it that the rest of the UK would abandon its nuclear deterrent following Scottish independence?

Lord West of Spithead: If I can start with the second question first, maybe: is it feasible? Yes, of course it is feasible. It will be very difficult and it would be costly. Based at Coulport and Faslane, we have a number of MCMVs. That is not a problem; there will be some debate about what split and things like that. We also have our SSN force; these are the attack nuclear submarines. They can move relatively easily down to Devonport. Indeed, there are SSNs based there now. There is a lovely new jetty called the Valiant jetty that was built specifically to support the Astute class submarines. That jetty floats and can be moved; I think it would be quite difficult and it would be expensive, because a lot of the shore linkages and things would have to be all redone, but it could be moved down to the south coast. The new training schools and everything for the Astute class that were going to go into Faslane would have to not be there and would have to be replicated down in the south, but it could be done—I say relatively easily, but there will be quite a lot of costs involved.

On the SSBNs, the actual submarines themselves clearly can go wherever they want, effectively, where there is enough depth of water for them. As you know, we refit the SSBNs in Plymouth at the moment, so they could go there. The problem really becomes the issue of warheads, the mating of warheads to missiles, and all of the support infrastructure—
the explosives handling jetty, all of those things—which are in Coulport. When the initial Trident programme was done, Prime Minister Thatcher was quite clever in that, when they talked about contingency, she said, “No. That is what it is going to cost. Add contingency on top”. That was quite sensible because, actually, the cost of all of that—producing Coulport and that area—was dramatically higher than anyone assessed it would be, but because she had allowed such a big lump of money we came in under cost for Trident, so it was quite cleverly done and one could always say that we were under costs, but it was a large, large sum of money.

I have asked specifically of the MoD to break out those costs and they surprisingly—I was very surprised—said in answer to a Written Question of mine that it was too difficult to find these costs. I find that unbelievable, so I am quite tempted to do an FoI. I have found in the past that an FoI finds things that maybe PQs do not, but that it is a slightly different issue. So it is a lot of money.

Looking down south, where do we want to put these things? You want to put your ballistic missile submarines in a position where they have egress to the areas they operate in, the deep oceans of the world, with as many opportunities to get out as possible. Somewhere like Milford Haven would be very good, because you can go south of Ireland or north of Ireland. You can cut up in through the Cumbras, as we can with the base we have at the moment. Places like Falmouth are probably not quite as good—although you could take one on the surface through the Channel, effectively you have only one exit route until you get round the corner of Land’s End—but that could work.

There are then huge issues with the local population: who would be happy to have that facility set up? You would then have to do all the infrastructure work. It is extremely difficult to put a figure on it. Plucking it out of the air, I would say that it would be something like £4 billion. That £4 billion would need to be spent very rapidly as soon as the decision was taken, if it were that they were not to be based in Scotland any more because of the separation of Scotland. That means that the cost would come just at the time of the big spend of capital costs on new ballistic missile submarines. We are not replacing the deterrent system; we are just replacing submarines that are getting very old.

I believe that that extra cost would make it quite problematic and very difficult in terms of the debate about whether we should go down the route of maintaining the current sort of deterrent. You would be suddenly adding a lot of extra money in those years. The Treasury would, I believe, have to find the money, because I do not think that the MoD could. In the second 10 years, although there is talk of a balanced budget, there are a number of programmes that are not yet properly funded. That means that this whole thing would be called into question. That is why I arrived at the conclusion that there would be a different way of looking at this and that some people might say, “We do not want to do it”. That would be unfortunate, because I have no doubt that if we wish to be in the deterrent game, the submarine-launched ballistic missiles of the Trident system are the most cost-effective way of us doing that. There is talk of other options. I have been involved in looking at other options on a number of occasions and they just do not add up. I am sure that the latest study will show that as well—unless you want to go for something totally different and say, “We can make a bomb when we want it and we will work out what we do thereafter”. I just do not believe that has any sensible relevance. Does that answer your question?

The Chairman: I think it is a very good start, and we have a lot of questions following on from that. I am going to call Lord McFall because he has to go soon because he is chairing a sub-committee of the Banking Commission.
Q846 Lord McFall of Alcluith: Lord West, you mentioned the issue of risk. If this was a possibility for any other service—the Army or the RAF—what would be happening now about a contingency that could happen in a few years' time?

Lord West of Spithead: Our job in the military is to look at risks and possibilities. Our job is to look at how we could tackle them. If the Government are genuinely not doing any work on this, as I say, I think that is a dereliction of duty. These are hugely complex issues. Is Aldermaston still going to produce the weapons, which will be stored at Burghfield and Aldermaston. If they cannot now be stored up in Coulport, where will they be put? Will they be put in a temporary place? Will we take them out of there? Do they have to be moved within a matter of weeks or months? What are the timescales? Will we be able to keep submarines there? For how long? How long will there be to remove them? Will there be a debate about what bit of current military hardware in Scotland expects to get and how we balance this?

These are hugely complex issues, and to start addressing them the moment after there has been an election I find extraordinary as a military man. As a military man, I would want to be looking at all of those options and then coming up with what I would see as the best option for the United Kingdom—no doubt someone would be looking for the best options for Scotland.

There is an overall thing. I have no doubt whatever that a separation of Scotland will diminish us all. Within Scotland, there are some amazing military people. I have served with them all my life. I was educated in Scotland. It will make us all lesser if we go down the route of Scotland becoming a bit like Ireland—which, I fear, to put it bluntly, has actually ridden on the back of our defence and security since the 1920s—that makes it a lot harder for the rest of the United Kingdom to bear that weight and, as I said, it diminishes us all in defence terms.

Q847 Lord McFall of Alcluith: You mentioned your education. I know that you were at Clydebank High School, which was in my constituency, and I represented the Faslane base for many years, where we had more than 10,000 direct and indirect jobs and £300 million got into the local economy. What impact do you think that this uncertainty could have for the local community and what could it have for Faslane as a base? We are told that it is just a transfer from A to B and everything should go along as it was before and it would be the strategic hub of an independent Scotland.

Lord West of Spithead: If Scotland separated, there is no doubt in my mind that the ballistic submarine force and the SSN force would have to move from there. At the moment, there are more than 6,000 people employed in the Faslane complex. The plan is that that will rise to 8,000, because of all the submarines being focused there. That does not take into account firms making periscopes and all the other things in that region. When one looks at the amount of money that a separated Scotland would have for defence and makes some sensible assessments of where it would pitch their spend, one probably comes up with something like £1.7 billion a year. If they are doing that, and if I was their Defence Minister and I was setting up forces at that sort of level, I would end up probably needing a very small base on the west coast of Scotland and a very small base on the east coast of Scotland.

When I say small, if I was being excessive and employed rather more than I should, it would probably be 500 people in each. That is about it.

When I say that there have been some deliberately misleading things, a question was asked about how many were involved in Coulport and Faslane to do with the ballistic missile force. That was a slightly misleading question because it did not point out that all of the nuclear
submarines would go. It was talking about the crews and the direct crew involvement, so they came up with a figure of 500. That is misleading. There would be 500 left; 5,500 would go. By 2022, there would be 7,500 fewer jobs, so it will have a huge impact. I cannot see that it will not.

**Q848 Lord McFall of Alcluith:** You mentioned the SSN attack force and the Astute class submarines. I was involved at the time in lobbying to make sure that it went to Faslane. We have a 20 to 25-year horizon for them there, so there is good long-term planning there. Given that that is removed, and given your knowledge of Scotland, having been educated there but also having been based in Faslane for many years, can you give us an idea of what the defence infrastructure and architecture would look like in Scotland after the possible withdrawal?

**Lord West of Spithead:** Again, I think that this is why we should all be looking now at all the options, because you cannot lay out some of these figures. I came up with the £1.7 billion figure. Because I knew I was coming here, I did some work on this. The sort of force that I think that one would be looking at would be a force of about 10,000 full-service troops, perhaps 13,000 reservists, no heavy artillery, tanks or anything like that, some attack helicopters—they could take a chunk of ours—so perhaps a squadron of attack helicopters, some Chinooks and Merlin helicopters for lift. I think they would want to take, initially, some of our frigates. Of course, that would have a huge impact, because we do not have enough destroyers and frigates in the United Kingdom anyway, but they would probably want to take, say, three. They would not take any of the nuclear stuff, so all that will go away. Really, what they would want for the future would be eight medium-sized offshore patrol vessels. That would be what I would be pitching for if I was a Scottish Secretary of State for Defence.

They would probably get a squadron of fast jets. I think, after a time, they would wonder whether they were really worth the candle. That means that the two huge airbases up there, which cost a lot of money to run, would probably close. You could keep one open and shrink it dramatically, but in the long term, if you did not bother to have fast jets, which might be quite sensible, you would probably say, “Let’s have a military enclave at the Glasgow and Edinburgh airports”, and run them that way. We are talking about a huge drawdown. With those numbers of troops, we are talking about closure of a number of barracks as well.

**The Chairman:** I think we are going to have to stop; there is a Division in the Lords.

*Sitting suspended for a Division.*

**Q849 The Chairman:** I apologise for interrupting your response, but we had to vote. Perhaps you would like to carry on.

**Lord West of Spithead:** Yes, I was outlining the sort of scale and size that I would imagine a defence force would be in Scotland, assuming that they would be spending about £1.7 billion a year. That, I think, is a fair assessment of the amount that they would spend. Ireland spends £0.6 billion and Denmark and Norway spend a little more, but they have larger GDPs overall. One of the other costs hidden in all of this, which is why it restrains what they can do, is that they would need to build new headquarters, move people south and north and resolve all of those issues. There is a whole manpower control area like within the Royal Navy’s Second SEALord’s world. They would have to have an equivalent of that for all the
manpower. They would have to establish training schools, certainly for the lower echelon of training—for new entry for the first part of training for all three services. For the higher level—higher command staff—they could pay to have them trained in United Kingdom, America or wherever they wanted to do it. They would have to establish a completely new logistics infrastructure, so there would be all the costs of that. They would have to think about how they resolve the GCHQ issue. How will that be done? Edzell used to be a separate operator but that is all closed down now. How would they do all of that, what exactly are their requirements in that area? What sort of SIGINT do they need? What is required? They would have to think about the SIS. Will they have an overseas intelligence service? How will that be established and run? What is their grand, strategic overview? How do they see themselves operating in the context of NATO, within a possible EU force in the future, within the UN? How do they see that? Ireland, for example, provides forces for the UN. All of these things add up to an awful lot of costs for getting all of that resolved. That has to be taken into account within the budget. I can see that that is adding to the pressure to reduce the size. I know that there has been a lot of loose talk about all sorts of forces by some people within the SNP. But I just cannot see it because of all those pressures.

Q850 Lord Lipsey: You have given a comprehensive assessment of what they would need, but I am not clear about what they would need them for, apart from a few peacekeepers and strike-breakers. Why cannot they just be a neutral little country sitting there cheerfully without defence?

Lord West of Spithead: I think the answer is they could do rather what Ireland has done. I talked about this £1.7 billion because the SNP has been quite hard over in saying that they would have reasonable defence forces. Yes, they could do what Ireland has done. I think that that diminishes the defence of our islands. We protected Ireland during the Second World War. Ireland sat happily under the NATO umbrella, stashed out of the Atlantic side of us, and we paid for it. We paid the money to look after them. If we suddenly find that Scotland is doing the same, then we have to look after two countries that are not pulling their weight in that overall grand strategic context. When one looks north, with the melting of the Arctic ice cap, with the larger number of ships beginning to go through there and with the way the Russians are starting to talk about the seabed up there, this is becoming quite an important area. If Scotland suddenly said, “We’re going to send a few UN peacekeepers, but we don’t really want to do anything else. There will be a maritime control and we will look after our fisheries”—yes, they could do that and they would spend a lot less. The impact on the number of people working in defence would be even greater. Even more jobs would be gone. We would be talking 20,000 or 25,000 jobs gone. It would have an even greater impact if that were done. That is why they need a grand strategic overview of what they want Scotland to do. I hope that this never comes to pass, but a separate Scotland would have to think about that.

Q851 Lord Tugendhat: Before I come to my question, I must say a word in favour of the Irish.

Lord West of Spithead: I am not having a go at them too much.

Lord Tugendhat: I think that I am right in saying that during the Second World War, men from what was then the Free State accumulated a greater number of gallantry medals than men from what was then Northern Ireland. We were defending them, but they did do a bit in return.
Lord West of Spithead: I would not get into a ding-dong on gallantry. All I would say is that there were some very good fighters in Ireland, in Northern Ireland and Scotland. Regiments such as the Connaught Rangers, when they were in the British Army, were amazing. One only needs to look at the Napoleonic wars and things like that. They did not let us use Queenstown and they were not spending so much on defence. Actually, if we had not been there and if we had lost, the Germans would not have stopped and said we are not going into Ireland. Let us not kid ourselves: Hitler would have done.

Lord Tugendhat: I agree with all that; I just wanted to put in a bit of a plug for them. I recognise that your first-hand experience is in the Navy, but do you have any idea what proportion of those serving in the Scottish regiments are actually Scottish? By that, I mean not only people from other parts of the United Kingdom but people from Fiji and other Commonwealth countries who serve in the British Army and who are, I believe, quite strongly represented in the Scottish regiments.

Lord West of Spithead: The answer is that I do not know those details. We are able to recruit a number of people from Scotland. There is a martial spirit in Scotland, an impressive martial spirit, which is part of the reason that I am rather sad that anyone should think of it not being part of the United Kingdom, but I do not know those exact figures. I know that they have a number of Fijians, because that is why they normally beat the Navy at rugby, but I would not go any further than that.

Q852 Lord Lawson of Blaby: I entirely agree with you that the failure of the Ministry of Defence to do any contingency planning is most regrettable. I suppose that what they would say—they have not said this to us, but if they were talking privately—is that should the Scots vote in favour of independence, a whole lot of open issues will remain to be negotiated between Scotland and the rest of the United Kingdom. This would be one of the matters that we put into the negotiations with Scotland, and therefore you cannot look at it on its own, aside from the overall negotiations. It might be possible, although it is not SNP policy, as part of the negotiations, as a quid pro quo, and so on, for us to continue to use the existing bases for the nuclear deterrent. It would mean of course that our nuclear deterrent was on foreign soil, because Scotland would be a sovereign country. Nevertheless, that might be a matter for negotiation. We have had overseas bases—not of a nuclear kind—on a number of occasions.

Taking that further, if we accept the principle that it is conceivable that we would have our nuclear deterrent—I am assuming that we wish to retain a nuclear deterrent; that is not the job of this Committee to decide—on foreign soil, there is alternative foreign soil. This was put to us by Francis Tusa. The French, who are not all that far away, have very full facilities in the Brest area. They may be keener to have us there than would an SNP Government in Scotland. That might be a possibility.

You have talked—this is obviously the frontrunner, in a sense—of the English option. Would you like to say a few words about the Scottish option post-independence and the French option?

Lord West of Spithead: Certainly. I accept that people could be saying, “Gosh, there’ll be so many negotiations, why look at these ones?” but I think, as a military man, there is merit in making sure that you have some options available, because you do not know how much time they might be to take certain actions. One example that I would give is that BAE at the moment is looking at closing its Portsmouth shipbuilding capability. It has an amazing capability in Scotstoun on the Clyde. It is superb. It has very skilful workers. But I find it
inconceivable that the United Kingdom, separate from Scotland, would have its warships built in a Scottish yard. We know from some of the work done by RUSI that 35% of everything you spend on a contract within your country go straight back to the Treasury in taxes and things like that—not to mention the infrastructure, the trained jobs.

We need to quickly resolve these issues, because BAE is about to start making decisions on this. It would be a dreadful business if we closed quite a good facility in the south of England and then, suddenly, God forfend, the Scots vote to be separate and there is a big debate because we are not going to build them there and we have to do it sub-optimally—it may be tacked onto things in Barrow. I am just explaining why some things really need to be looked at now.

As regards the bases, if I may touch the foreign basing first, I cannot see it being practical and achievable to base our nuclear warheads in an enclave in France. We would have to have complete control of that bit of land. It would have to be like an enclave and I cannot see how we could achieve it. I think that the negotiations to do that would be extremely difficult. We would need the ability to ensure getting to them if periods of tension built up and we had different views. I could see that being really difficult.

It would probably be fractionally easier with America, but there are all the issues then of, when you do your work on the new warheads in AWE, transporting them over to the States and storing them somehow. You would have to do your mating of missiles and warheads over there. Again, I think it is not something one would like to do. One needs to look at all the options. I am not sure what all the costs are or what are all the legal implications.

As regards an enclave staying in Scotland, in a sense, that would have to happen initially on the day of the vote, if the vote was that Scotland should separate, because you cannot just move it straight away. One would have to come up with some debate about how long until we moved in, but looking ahead, one would be doing it on the basis that we are going to get out. We are not going to leave our attack submarines and our ballistic missile submarines based there; we have to look at some other way to do it. There are a number of ways of skinning the cat in the short term. For example, you could put more warheads on to missiles. You could send some of those warheads down to Burghfield and Aldermaston. We have 58 missiles; we do not use many of them at the moment in the submarines because of the restrictions; there will be issues about the NPT and we have will have to debate that and get clearances; but there are other ways of doing it which I certainly think are more appropriate for an independent deterrent than trying to do those other things. I certainly would not say that it is impossible; of course it could be done. Of the three, the base in Scotland, how long does that go on for? That would have to be the most likely. The other two I do not think are really starters, but we need to look at all the implications before one can draw full conclusions.

Q853 Lord Skidelsky: Following on from that, thinking about contingencies, has the Ministry of Defence looked at the experience of other states that have broken up with nuclear weapons? I am thinking of the breakup of the Soviet Union. What happened to the dispositions of their nuclear forces when the Baltic states became independent, when Ukraine became independent, and so on? Has one looked at what happened there?

Lord West of Spithead: We seem to have been told that the Government and the MoD at the moment are not looking at any contingencies, but historically—I was Chief of Defence Intelligence at the time that the Soviet Union collapsed—we watched very carefully where nuclear weapons and warheads went and what was happening to them. Basically, they were
pulled out of all of the other states. They were not left there, but it took time to achieve that. The Kaliningrad oblast in the west still had weapons, but of course it was controlled by Russia, effectively. We have knowledge of exactly what happened there but, as we have said, no one is looking at this now. As Lord Lawson raises, things like that are so complex that there should be MoD lawyers looking at this saying, “What could we do?” I would hope that we would have that in our back pocket. We certainly need it for the negotiations. Yes, negotiations will go on for a while but it would be quite nice to have those there and think how we are going to approach all those questions.

Q854 Lord Forsyth of Drumlean: Lord West, if you could just think back to when you were First Sea Lord, if you were in the position now where there was the possibility that a Scottish Government which are committed to making Scotland a nuclear-free zone—whatever that means—win the referendum and we have independence, would it not be a dereliction of duty not to look at what the consequences were and prepare a plan B? I have never been a Defence Minister and I have never been in the armed services, but I always imagined that what they did in the Ministry of Defence was consider all possible options, including the most unlikely, and prepare plans and be prepared for any eventuality. That is what I thought defence of the country was about. Is it not an extraordinary position for the MoD to take that they are not making any preparations—not even to the point where they would be able to carry out negotiations?

Lord West of Spithead: I could not agree more. As I said in my opening, if they really are not doing any work—maybe they are and they have not told us—it is a dereliction of duty, because this is too important for the nation to allow to be done, as I said, in slight shorthand, on the back of a fag packet. It has got to be clearly thought through. I find the position of the SNP on nuclear quite problematic, in a sense, in relation to NATO. There has been talk about other NATO countries not having nuclear weapons, but no NATO country have said, “You can’t bring a nuclear weapon into my waters or on to my land”. All of them have signed up to a nuclear umbrella. It seems extraordinary, if you want to join NATO, if you do not agree. I cannot quite see how that works, and I will be very interested to see how that works. If you are part of NATO, you should pull your weight. Going back to the question Lord Lipsey talked to me about—“Why don’t they just have forces like Ireland?”—Ireland are not part of NATO. That is why they get away with not doing that. If they are part of NATO, you have to pull your weight a little bit more, or else you are not really part of NATO.

To go back to your original question: absolutely. I am amazed. If they really are not doing any contingency work, I think it is appalling and, going back to when I was First Sea Lord, as I said, I would be turning a Nelsonic blind eye to this and doing it. Life was much simpler when I was First Sea Lord.

Lord Forsyth of Drumlean: Just to fill in the blanks in my knowledge: I also imagined that the whole point of us having Trident and an independent nuclear deterrent was that first word—that it was an independent nuclear deterrent. Do not all the schemes that have been discussed—you know, we could have an enclave in a Scotland that might be hostile to nuclear weapons, or we could be in France, or we could be in America—defeat the purpose of having the deterrent in the first place: that it is independent? The idea that you could use—not that one would ever want to do so—those weapons based in a foreign country seems to me to be an absurdity. What am I missing here?

Lord West of Spithead: Over time, that is absolutely right, and that is what I hope I put across as the picture. Of course at this instant there is, under the sea, out there in the
ocean, one of our ballistic missile submarines which is carrying a payload. It is a much reduced payload because, unlike most countries who have nuclear weapons in the world, we have done amazingly in reducing the number of warheads and everything like that. But it is there and, of course, if it were required for the ultimate insurance policy of this nation, the Prime Minister can actually use it. The fact that you have an enclave somewhere else would not stop that in the short term. In the longer term, I believe it would have an impact on it and that would stop it being independent.

There is no doubt there is a lot of nonsense talked about, “Is this really independent because of the Americans?” I have crawled all over this system, from top to bottom, and know the way it works, functions, and how we have the missiles refurbished in America—they are in a huge storage facility, our people go and the Americans do not know which one we are going to pick; we say, “We’ll have that one”, so it could be one that was going to go to America. We know exactly how the missiles function and work. We have got our own warheads. These things are absolutely independent. We have got control of them.

Lord Forsyth of Drumlean: A third point: I live not a stone’s throw away from Faslane, and we have always understood that the facilities at Faslane and elsewhere on the west coast were absolutely the best—the ideal—location for our independent nuclear deterrent, because of the number of exits and ways in and out and because of the water. If Scotland did vote for independence and, as we appear to be agreed, that would mean moving the independent nuclear deterrent, would the other options mean not just that our security as the United Kingdom but that the overall defence capability of NATO would have been reduced?

Lord West of Spithead: I cannot think of any of the other options that would be as good as where we have got it at the moment, so there would therefore be a diminution in that capability. We would still be able to deploy a submarine, I am sure, say from Milford Haven, and once they are in the oceans we know very well that nobody has ever got in the trail of one—although one did bump into a French one, amazingly, which shows how quiet they are. We know that once they are out there, they are all right. But it would be a diminution, because it is not the optimum place to put them. There is no doubt that the Faslane-Coulport set-up is perfect for that, and for training—for doing initial dives. There are all sorts of aspects to do with the training, maintenance, running and operations of them that make it ideal, and I cannot think of somewhere else in the UK that would be as ideal.

Q855 Lord Levene of Portsoken: If Scotland were to vote for independence, how do you think it might be best to try to divide the non-nuclear submarine defence assets that are in Scotland? Obviously, there is a fair spread of many others. How do you think that could be divided up, leaving to one side the—

Lord West of Spithead: Sorry, you were talking about the other naval assets?

Lord Levene of Portsoken: No, the total defence assets in Scotland.

Lord West of Spithead: If I can start maybe with the naval side, there is no way that they would take any nuclear submarines. With a defence budget of that size, it would absorb the entire budget, so they would all go. Some people have talked loosely of them creating a conventional submarine force; they could not afford to do that. Although there is a nuclear ownership cost, conventional submarines now are actually two-thirds the cost of a nuclear submarine, so to establish a conventional submarine force again would effectively take the whole budget to achieve that.
Then you come to surface ships. They could not handle the Type 45s— the complexity of them, all of the equipment, the base-porting stuff is down in Portsmouth and it would be very expensive to try and resolve that— so they would look at the Type 23 frigates. If you look at 10%, say, of what we have got, there would be some debate and they would end up maybe getting three or four of those— again, a great diminution of our capability, because we only have 19 destroyers and frigates. You need three for one deployed, so effectively this country— the United Kingdom— would have five deployable escorts. It is unbelievable, really, is it not? Nelson would turn in his grave.

So that is pretty worrying, but that is what they would go for, I think. They would probably want some of the MCMV vessels, so they would get a small number of those. They would probably try and get, in the discussions, one or two— probably one— of the fishery protection vessels; they do have Department of Agriculture and Fisheries (DAF) already, but they would like a warship for that to add to it. They would probably want to get one of the Bay-class landing platform docks, because that is useful for transporting forces should they do a UN mission; so they would get one of those, which would diminish the overall amphibious capability that at the moment our islands’ have. That would be the sort of split, and they might ask for a tanker or something. Looking longer term, they would probably get rid of the Type 23 frigates and would go for a much simpler vessel to patrol the exclusive economic zone.

As regards aircraft, if you look at all the costs and everything, they could probably get a squadron of stet. They would need a training squadron as well, so there would probably be two squadrons there. Sorry, I mean Typhoons— they would not go for the Tornadoes, I do not believe, because these are coming to the end of their life and are going to disappear. Those are very expensive and, very quickly, they might find, looking to the future at the sort of force they are going to have, that this is not something that they really wanted.

They would, however, go for helicopters, of course, for the lift for the troops they have got. That would be maybe a squadron of Chinooks. When I say a squadron, we are talking about probably four or five Chinooks and, say, maybe eight or so Merlin helicopters. I doubt if they would go for any of the long-range transport. They might want a C17; again, it would be part of the debate, because if they do UN operations that sort of aircraft is very valuable, but the maintenance, running and everything else of one unit is very expensive.

When it comes to troops, from the sorts of figures they have been talking about, I reckon you would probably end up with about 10,000 regular service troops. The structure would have to be totally different. You cannot take whole regiments in. You could not take a UK regiment and put it there, because they have to set up all the training infrastructure, logistics infrastructure and all this sort of stuff. When you break things down into sub-optimal amounts, you end up with a front line that is dramatically smaller.

**Q856 Lord Levene of Portsoken:** Would the Air Force be underweight in equipment but overweight in facilities?

**Lord West of Spithead:** Yes, because we have some amazing airbases up there. I am sure that in future they would want to negotiate with NATO to use low-flying areas and ranges, because they have that up there, but I cannot see that they could keep the airbases that are there open. There is no doubt that they would have to close. The amount that they put into the local economy is dramatic.

**Lord Levene of Portsoken:** But the point that I was trying to make was that they would not have need for that number.
Lord West of Spithead—Oral evidence (QQ 844-863)

Lord West of Spithead: No.

Lord Levene of Portsoken: But it would leave the rest of the UK sadly underequipped of airbases.

Lord West of Spithead: I think that we would find that the bases that we have in the south for fast jets would be very heavily loaded.

The Chairman: When we have looked at the question of dividing assets and liabilities beyond the defence field, there have been a number of ways in which it can be done and some estimates based on population, and so on. It sounds to me that in defence, you could not do the split that way, you almost have to start again—the Scots have to start again—thinking what defence capabilities they want and the implications for the rest of United Kingdom follow from that. Is that right?

Lord West of Spithead: I think that they need to know what they intend spending on defence. They then have to cut their cloth, but in the initial years, there are all sorts of variables. For example, if we are moving from Faslane, I am sure that part of the negotiation would be, “You are making us move out of a purpose-built base. We have just put in new accommodation for all the unmarrieds and marrieds. We have just finished a whole new submarine training complex et cetera. To move this all south is going to cost £4 billion and this vote has made that happen”. That would all be part of the negotiations, I am sure. The complexity of those is quite mindboggling, but because they would have to recreate all the infrastructure that is there at the moment for the whole of the United Kingdom forces, there would be a lot of extra cost for them, because the smaller you make something, the bit that gets reduced quickest—it has happened to the United Kingdom as a whole—is the front line. All that background support infrastructure costs a lot.

A separate Scotland would have to think very carefully about exactly what infrastructure it wants: is it going to do training elsewhere; is it to be UN-focused; is it to be EU-focused; is it to be NATO-focused? What will be the key thing? Or will it be to look after their own waters? I imagine that their own waters and oil would be very important to protect, so you would want some simple maritime patrol aircraft, quite a simple thing with a radar. You would want small fishery type vessels. If I was their Secretary of State for Defence, I would say, “We have £1.7 billion. We have to achieve this. This is what we have to focus on”. Therefore, to talk about them speaking of defence in the terms that we talk of it now in the United Kingdom is, I am afraid, misleading people. I think it is deluding some Scottish people. I do not think that they have been honest about it.

Q857 Lord Skidelsky: Look at it from the side of the UK for a moment, and leave aside the impact of the locational changes on defence capability. If Scotland became independent, do you think that the rest of the UK, despite having a smaller tax base, would want to maintain its current level of military capability? How sustainable might that be, given that present budgetary constraints are tight? In that case, would the military budget have to be a higher proportion of GDP than it is at the moment?

Lord West of Spithead: That is a very important and worrying question. Judging by the willingness at the moment to spend on defence, I think that there would be a diminution in our defence capability greater than just the fact that Scotland had withdrawn. I am on record as saying that I believe that we should spend 3% of our nation’s GDP on defence; I think we have cut it too much. The implications of this and the separation of Scotland are that we would be spending an importantly smaller amount on defence, which always has a
dramatically larger impact on your front-line capability. I find that very worrying, because I do not believe that we have sufficient spending on defence at the moment.

With all the pressures one has—demographic pressures, pressures on economic resources looking to the future, pressures of religious extremism, countries wanting to break up—we are in a highly dangerous, very volatile world and I think we could get our fingers burnt by not having the capability to look after our interests globally. We still have global interests; we are still the sixth or seventh wealthiest country in the world, depending on how you calculate it. More of our percentage of our wealth of our GDP than any other of the big countries is in export and import. We run world shipping from here, and world shipping is a sinew for our global village. All that makes it very important that we look after those things.

We are the biggest European investor in South-East Asia, South Asia, the Pacific Rim. They are all British investments and they all need to be looked after, but I do not think that we are. The separation of Scotland would add to the impact on that and I find that very worrying as a military man.

**Lord Skidelsky:** You cannot see a British Government—an English Government—going to the people and saying, “Now that Scotland has left us, we had to spend 4% of our GDP on defence”?

**Lord West of Spithead:** Certainly, when I talked with people in a position to do something about it, they showed no inclination whatever to do that.

**Q858 Lord Levene of Portsoken:** As a follow-up to Lord Skidelsky’s question, you have been skirting what is a sensible structure for a Scottish defence force to have in future. Clearly, it would be a much smaller country, it would have a much smaller budget, and so on. I am just thinking about what the effect on the UK would be supposing that in Scotland they said, “We are not really interested in defence at all; we do not have to do any of that”. That would presumably leave a large part of our defence which was geographically in Scotland exposed, so we would have to find some way to set up protection where we have relied on the Scottish defence component to protect us in the north. Presumably that would add even more to the costs that we would have to provide for in future.

**Lord West of Spithead:** Certainly, when one looks at the defence of our islands, one has always assumed that one would be able to use bases in the very north of our islands to do that. If we did not have those then, suddenly, incursions from Russia and problems in the Arctic, and things like that, become rather more difficult to handle when the furthest north you can go is into either Northern Ireland or Berwick-upon-Tweed, which is hardly a huge base. So yes, it would have an impact, without a doubt.

**Lord Levene of Portsoken:** But without those bases, and leaving to one side for the moment the question of cost, how could one put in place that protection if you had an open border?

**Lord West of Spithead:** Well, there would be issues. It depends. If Scotland is part of NATO, the airspace becomes NATO air space and you can do things in it. If it does not, you have issues. You cannot put UK, English, Welsh and Northern Ireland military aircraft, through Scottish airspace without the approval of Scotland. They are saying that they will join NATO, so that solves that problem, but there are all sorts of issues like that. There is no doubt about it.
I am in contact with a lot of Orcadians who are friends of mine who are saying that if Scotland separated, they would like to separate from Scotland and use Scapa Flow again. We will have to see what happens then, but that is a little bit remote.

**Q859 Lord Hollick:** Let us go a little further down this path. It would seem that, shorn of the contribution from Scotland, the rest of the UK, the remaining UK, would be at a level of expenditure that may not sustain what we regard and understand today to be a conventional defence investment. I would be interested in your views on what the options are for that, but that might lead to a severe scaling back of some very expensive conventional equipment. You mentioned Typhoon. Is Typhoon going to be the last of its line? Will we now move to drones, which appear to be far cheaper, have great range and do not involve body bags coming back. In other words, would we be forced, because of the diseconomies of scale, to completely rethink what we can do in the realm of defence, to do all the things that you have just described. If we were to rethink it, what would it look like?

**Lord West of Spithead:** Gosh, that is quite a wide-ranging question. In terms of expenditure, I have done quite a lot of work looking at how much countries spend as a percentage of GDP and what impact it has. There is no doubt that, if you go above 4% and do that year after year, it does start impacting on other aspects of your economy. There are some countries that do it, but there are skewed issues that allow them to do it and it is damaging. That is why I think that the 3% level is a very sensible level of defence expenditure. We are going down now to 2%, and probably slightly less than 2%, which I believe is too little for a nation like ourselves. When it comes to what sort of force structures we are looking at, I believe that the Joint Strike Fighter will be the last manned fighter. I do not believe there will be any after that. UCAVs—unmanned combat air vehicles—will take over from that, or there will be smart missiles with longer ranges and this sort of thing, so I think that will be the last of that type of aircraft. I think one would have to look very carefully at the numbers of the manned aircraft you need to fulfil certain things.

Drones are amazing. They are particularly good for reconnaissance and things like that. Yes, they have killed a lot of rather nasty Taliban people but, equally, it is quite difficult at times to know who else you are killing as well. I do have concerns about some chap sitting in a hut in East Anglia who has the authority to take out something that might be a wedding party. Who has the authority? I have considerable concerns about that. I also have considerable concerns on the impact on them mentally when they are doing things like that regularly, and there are issues about airspace control.

There are a whole raft of issues, and there is no doubt that when you put a man into a plane it is incredible how men can still do things computers cannot. If you have not actually programmed a computer to expect something weird like a man with a green head suddenly appearing and sitting on the wing, the computer would never say that that has happened; it would ignore it, whereas a man might consider that something strange had happened and that this had come from outer space. That is the sort of thing that happens.

They are not the complete panacea, but there is no doubt they are amazing. I think there is a real danger as well of having wars where you think, “Well, we’re not taking casualties”. As a military person, it is easy to say—and I know—wars are bloody unpleasant and horrible and do horrible things to people. If people do not see that, then we are in a very dangerous world, and I worry about that as well. They do let you do some things in a different way. The whole area of cyberwarfare; the whole area of better use of positional and instant data on where things are; precision weapons—things like electromagnetic guns for naval gunfire support, where you fire it electrically and it goes 180 miles and it will land within this desk,
but with no explosives required because it is travelling at such an immense speed the kinetic energy does it—these sorts of things are all there and can be done, but it does not get round the basic fact that you still need to spend a certain amount of money on the overall structure of your military and some of these things.

Going on to the procurement aspect—again, I have not really mentioned this yet—in a separate Scotland, the amount of money they would have for procurement spend would be very tiny. That means, again, that you are not going to be able to have firms in Scotland, because defence firms go where the money is, and therefore they will go. That has a real implication. There is a history of amazing technological and inventive capability in Scotland. Some of that has gone into the defence and military sphere, to great advantage for our nation. That, I fear, would go. Once upon a time, it was Scottish engineers everywhere in ships around the world. I fear that all these Scottish people will be coming down to England and going to other places to use all those skills, and I think that is very sad.

Q860 Lord Rowe-Beddoe: Lord West, I share your profound concern that you have mentioned a few times with regard to the lack of planning as it is alleged; we do not really know. Do you think it might be a subterfuge?

Lord West of Spithead: I hope it is. Certainly, as I said, if I was First Sea Lord, I would have a Nelsonic blind eye to this and I would have people working on it, but then I have always been a bit naughty and not done what I have been told always.

Lord Rowe-Beddoe: Well, I am sure that some of your successors are equally as naughty. Please God they are. It is actually rather similar to the UK Governments position in general on this issue. We have had a number of witnesses in these hearings and so on producing options and options, but nobody seems to say when it is that we are going to be actually putting the cards right on the table. It is very concerning.

I have got some questions here now and, at the end of your very extensive oral testimony—it has been very interesting—you have covered most of the things that we were actually going to ask you about. One is a little redundant, but it is my question so I will pose it in a slightly different way. You have used on a number of occasions the idea of you being the Secretary of State for Defence, and I think we are very clear as to what you would be advising your Prime Minister in an independent Scotland. I think it is self-explanatory—it answers itself from what you have said already—but do you think that you would be settling for some sort of Scandinavian level of expenditure? You have talked about the 0.6% and the 1% of Ireland and so on. Where would you be trying to advise?

Lord West of Spithead: I think I would be selfish, and work on the basis that the United Kingdom would still look after the real, important aspects of defence, and I would look at being able to organise a robust structure that enabled me to look after my assets like oil rigs and fishing, and if there were civil problems or flooding—a structure to enable that, helicopters to move things round, a little bit of maritime patrol and some ships to do that, I would be very selfish, I think—you have made me now the Scottish Secretary of State for Defence—and I would say, “Don’t worry. They’ll actually carry this burden. Let’s let them carry it, with this very small amount of money that you are letting me have”, which I believe will get smaller as time goes on, because everything that one has seen of the way that SNP has historically approached defence makes one believe that. It is funny, is it not, how it slightly changed the moment this is going on. That would be the most sensible thing to do and advise—damaging to the defence overall of these islands, and rather relying on the
United Kingdom, but I think that is probably what I would do. It does not sound very admirable, I know, but it is probably what I would do.

**Lord Rowe-Beddoe:** Even against what you perceive to be—or the reality of—a shrinking defence budget in the United Kingdom?

**Lord West of Spithead:** Yes, and I think that it is against the interests, actually, of the defence of our islands and the interests of our islands overall. Those interests are for Scotland as well as the United Kingdom—shipping and trade are in their interests—but it is probably what I would do. It is awful, is it not, but I think that it is what would happen. I fear it is what might well happen, looking to the future.

**Lord Rowe-Beddoe:** I was horrified when you brought up the question of 18 escort vessels and what that means, and if you take three away that comes down to 15. As a man who had the privilege to serve in the service in a Mediterranean Fleet of 69 vessels alone, I do not know how we could actually do what you are suggesting we do with an independent Scotland.

**Lord West of Spithead:** Yes. Ninety-four years ago last month, 344 warships including 33 battleships took the surrender of the High Seas Fleet into Scottish waters. It could make an admiral cry, could it not, really?

**Lord Forsyth of Drumlean:** Would you forgive me if I asked a slightly tabloid question, which is just following up from Lord Rowe-Beddoe’s point about how the Scottish set-up would look? One of the big populist campaigns which the nationalists run is to preserve the Scottish regiments. Could you just spell out to us what you think would happen to people like the Scots Guards and the other Scottish regiments in practice, given that the members of those regiments will have a view of where they want to go and the rest? The impression is given that, in an independent Scotland, everything would remain the same.

**Lord West of Spithead:** I am not a soldier, of course; I am not therefore a complete expert on the regimental system but, as I understand it, I do not believe that those regiments could just transfer to a new Scottish defence force.

**Lord Lawson of Blaby:** The Irish Guards did not.

**Lord West of Spithead:** Exactly.

**Lord Tugendhat:** They did not in Ireland, did they?

**Lord West of Spithead:** No. Absolutely. Therefore, I just do not think that is feasible. I do not think it would happen. I have to say that I think a lot of Scottish military people would prefer to be in a military that they thought was defending the whole of our islands—all of our islands—and had scope for doing proper sailoring and soldiering and airmanship than in something that was rather less. I think you might find quite a lot of chaps actually preferred to serve in the remaining part of the UK forces, so you might well find that the Scots Guards had even more Scots in them than they did in the past but were part still of the UK-rump army. That is how I would perceive it.

**Lord Lipsey:** The SNP recently voted to stay in NATO. If they do try to join the club, might NATO simply blacklist them?

**Lord West of Spithead:** I think NATO would ask some questions: “Are you happy to abide by our rules? Are you happy to sit under this nuclear umbrella? There is no risk, is there,
that you will say that nuclear weapons are not allowed to be in your waters or on your land if they happen to go there—not that they would normally be based there? Why are you telling the UK they've got to remove their weapons from your land?”—although we have discussed the fact that they would actually have to go. So I think there are some questions there. There are some other questions as well: “Do you see in the future that you will be contributing forces to NATO that will help in NATO’s overall capability, and will your spend be of more than 2%?” which is what NATO has said that countries should spend. I think there will be a whole raft of questions that will be asked. I do not think NATO generally likes blackballing, so I do not think that would happen, but there a lot of very difficult questions that I do not believe that the SNP have really thought through. I think this was a quick win for them to make it seem as though, actually, they had thought about those things; that is rather what I think they have done.

**Lord Lipsey:** It was a hard fought win—not by a huge majority—and only after the leadership had pulled out every finger possible to get the vote through. You have to think that it would be a tremendous challenge for an SNP Government of an independent Scotland, when these NATO questions came, to find an answer that did not cause their Government to collapse rather rapidly.

**Lord West of Spithead:** I cannot really comment on that. Obviously if they are fully part of NATO, are abiding by all the rules of NATO and are spending 2% on defence, that has to help the overall defence of our islands, but I do not believe that will happen.

**Q863 The Chairman:** Any other questions? Lord West, is there anything else you would like to say to us? We have had a pretty full session, but are there any other points that you think we have missed out on?

**Lord West of Spithead:** No, I think that I have said all the things that really I can say. I feel saddened by the thought that anyone might even want to be separate, because I think it will diminish us all. In defence terms, certainly, I think there are real implications and I have to say that I do not believe that some people—the SNP—when they started down this track, really had thought about these things. If you look back 12 months ago, they had absolutely not thought of these. I do not know other fields—I am not an expert in those—but if they have done the same in other fields, it makes me even more worried.

**The Chairman:** I think that many of us would echo that point. This has, in my view, been a very absorbing and very important session for us. I said at the beginning that we had started this inquiry because we felt that a lot of the issues had not been fully aired in public. I think that actually applies to defence in spades. It is the area that has been least discussed. You yourself described the complexity as mind-boggling, but we are very grateful to you for unravelling quite a lot of the complexity and for speaking on the background of great experience and expertise, so thank you very much indeed for coming to us and doing it so well.

**Lord West of Spithead:** Not at all. Thank you very much.